CBO'S REPORT ON THE ECONOMIC AND BUDGET OUTLOOK

Y 4. B 85/3: 103-1

CBO's Report on the Economic and Bu...

_NG

BEFORE THE

COMMITTEE ON THE BUDGET
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

HEARING HELD IN WASHINGTON, DC, FEBRUARY 3, 1993

Serial No. 103–1

Printed for the use of the Committee on the Budget

MAY 14 1993

U.S. GOVERNMENT PRINTING OFFICE

64-146 ⇆ WASHINGTON : 1993

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-040195-X

CBO'S REPORT ON THE ECONOMIC AND BUDGET OUTLOOK

Y 4. B 85/3: 103-1

CBO's Report on the Economic and Bu...

_NG

BEFORE THE

COMMITTEE ON THE BUDGET
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

HEARING HELD IN WASHINGTON, DC, FEBRUARY 3, 1993

Serial No. 103–1

Printed for the use of the Committee on the Budget

MAY 14 1993

U.S. GOVERNMENT PRINTING OFFICE

64-146 ⇆ WASHINGTON : 1993

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-040195-X

COMMITTEE ON THE BUDGET

MARTIN OLAV SABO, Minnesota, *Chairman*

RICHARD A. GEPHARDT, Missouri
DALE E. KILDEE, Michigan
ANTHONY C. BEILENSON, California
HOWARD L. BERMAN, California
ROBERT E. WISE, Jr., West Virginia
JOHN BRYANT, Texas
JOHN M. SPRATT, Jr., South Carolina
CHARLES W. STENHOLM, Texas
BARNEY FRANK, Massachusetts
JIM COOPER, Tennessee
LOUISE McINTOSH SLAUGHTER, New York
MIKE PARKER, Mississippi
WILLIAM J. COYNE, Pennsylvania
BARBARA B. KENNELLY, Connecticut
MICHAEL A. ANDREWS, Texas
ALAN B. MOLLOHAN, West Virginia
BART GORDON, Tennessee
DAVID E. PRICE, North Carolina
JERRY F. COSTELLO, Illinois
HARRY JOHNSTON, Florida
PATSY T. MINK, Hawaii
BILL ORTON, Utah
LUCIEN E. BLACKWELL, Pennsylvania
EARL POMEROY, North Dakota

JOHN R. KASICH, Ohio
J. ALEX McMILLAN, North Carolina
JIM KOLBE, Arizona
CHRISTOPHER SHAYS, Connecticut
OLYMPIA J. SNOWE, Maine
WALLY HERGER, California
JIM BUNNING, Kentucky
LAMAR S. SMITH, Texas
CHRISTOPHER COX, California
WAYNE ALLARD, Colorado
DAVID L. HOBSON, Ohio
DAN MILLER, Florida
RICK LAZIO, New York
BOB FRANKS, New Jersey
NICK SMITH, Michigan
BOB INGLIS, South Carolina
MARTIN R. HOKE, Ohio

EILEEN M. BAUMGARTNER, *Chief of Staff*
RICHARD E. MAY, *Republican Staff Director*

CONTENTS

Page

Hearing held in Washington, DC, February 3, 1993 1

Statement of:

Reischauer, Hon. Robert D., Director, Congressional Budget Office 2

Prepared statements, letters, supplemental materials, et cetera:

Costello, Hon. Jerry F., a Representative in Congress from the State of Illinois, prepared statement of 45

Reischauer, Hon. Robert D., Director, Congressional Budget Office, prepared statement of 5

Sabo, Hon. Martin Olav, a Representative in Congress from the State of Minnesota, prepared statement of 1

Stenholm, Hon. Charles W., a Representative in Congress from the State of Texas, prepared statement of 45

CBO'S REPORT ON THE ECONOMIC AND BUDGET OUTLOOK

WEDNESDAY, FEBRUARY 3, 1993

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., Room 210, Cannon House Office Building, Hon. Martin Olav Sabo, Chairman, presiding.

Members present: Representatives Sabo, Gephardt, Kildee, Beilenson, Spratt, Cooper, Parker, Coyne, Andrews of Texas, Price, Costello, Johnston, Mink, Orton, Blackwell, Pomeroy, Kasich, McMillan, Kolbe, Shays, Snowe, Smith of Texas, Cox of California, Miller of Florida, Lazio, Smith of Michigan, Inglis, and Hoke.

Chairman SABO. Good morning. The House Committee on the Budget is in session.

Today's hearing will be on the economic outlook and the budget. And I would like to welcome Dr. Robert Reischauer, the very knowledgeable Director of the Congressional Budget Office, to the committee.

I have a longer statement that I will put in the record, but we welcome you, and we also look forward to having you back 2 weeks from today on February 17th to visit with us in more detail about what is happening with health care costs in this country.

I expect it may be unavoidable that some questions relate to health care today, but I would remind committee members that that session is scheduled in 2 weeks, so it would be preferable if questions related to those subjects were not asked today.

[The prepared statement of Hon. Martin Olav Sabo follows:]

PREPARED STATEMENT OF HON. MARTIN OLAV SABO, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MINNESOTA

Good morning. The House Budget Committee is in session. Today's hearing will be on the economic outlook and the budget.

First, I would like to welcome Dr. Robert Reischauer, the very knowledgeable Director of the Congressional Budget Office.

Our goals are to ensure long-term economic growth, reduce the deficit, and control health care costs. As important as accomplishing these goals, however, is how we go about doing it.

All that we do must be done fairly. Any burdens to be borne must be distributed fairly, and we must strive to restore some of the fairness and progressivity that has been lost over the past decade.

Complicating this challenge is the fact that over the past 12 years the deficit has quadrupled. Today, we find ourselves in a Catch-22 situation: without a strong economy we cannot reduce the deficit, and without deficit reduction we cannot sustain a

strong economy. Further complications include painfully high unemployment, too little investment in R&D, and the need to coordinate fiscal and monetary policy.

Clearly, health care is a subject closely connected to our primary topic today: our economic future. Recent figures tell us that if we do nothing, the deficit will soon start rising again and could actually more than double—rising to $653 billion—by the year 2003. For the most part, this increase will be driven by the soaring costs of Federal health care programs.

Already, steps are being taken. This past week, President Clinton moved to give the States more flexibility in administering the medicaid program. He has appointed a task force to work on health care reform. His economic team, chaired by our former colleague Leon Panetta, is hard at work on plans to cut the deficit and invest for the future.

The decisions facing us are difficult ones, and the only reward for some of them will be the knowledge that we have done the right thing. Yet, just as I have encouraged President Clinton to act boldly, I hope this committee will act boldly. I also hope we will strive to replace gridlock with action.

Today's hearing is the first in a series that we will be holding. In the coming weeks we will hear from economists on the economic outlook, from experts on health care reform, and from a variety of others who will provide insights into resolving the current economic situation. Armed with this information, and with the President's budget as our starting point, we will work together to help shape a blueprint for the economic future of this country.

Welcome, and I look forward to working with all of you. It promises to be an interesting year.

Chairman SABO. Mr. Kasich?

Mr. KASICH. I want to welcome Dr. Reischauer this morning and we look forward to your testimony.

Chairman SABO. Thank you.

STATEMENT OF HON. ROBERT D. REISCHAUER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Dr. REISCHAUER. Thank you, Mr. Chairman and Mr. Kasich. I appreciate the opportunity to appear before this committee as we begin a new budget season.

With your permission, I am going to submit my prepared statement for the record of the hearing, and will summarize some of the major points that are covered in that testimony.

I will say a few words about four topics: CBO's economic forecast; our budget outlook; the economic consequences of major deficit reduction; and the lessons that we have learned over the last decade concerning the role that the budget process can make in controlling the deficit.

With respect to the economy, our view is little different from the consensus forecast. The economy appears to have entered a period of self-sustaining growth, by which I mean that further fiscal or monetary stimuli should not be required to keep the economy growing. That new growth will hardly be exhilirating. Over the course of the next 2 years, the economy should expand at roughly 3 percent a year, which is only three quarters of the pace that is typical for this stage of a business cycle.

This tepid growth will mean that the unemployment rate will decline very gradually. It will be a bit under 6.5 percent by the end of 1994. That is a far cry from the 5.3 percent that prevailed from late 1988 through mid-1990, a rate that we regarded as close to full capacity.

Of course, the slow pace of the expansion will keep inflationary pressures and interest rates low. The consumer price index should grow at only about 2¾ percent for the next few years, and interest

rates are expected to remain nearly constant through 1993. Short-term rates will rise a bit during 1994, once the expansion is fully established.

With respect to the budget outlook, the economic recovery will bring no relief from record-breaking deficits. The deficit will remain stuck near $300 billion for the next few years, and will begin to increase in the second half of the 1990's as the restraints that have been imposed by the Budget Enforcement Act dissipate and the large Federal health programs continue their inexorable double-digit growth rates.

If further steps are not taken to curb spending and increase taxes, the deficit could reach $650 billion, twice today's level, or 6.8 percent of gross domestic product (GDP), 10 years from now. Federal debt would then represent almost 80 percent of GDP, higher than any time since 1950, when we were burdened by the debt that was accumulated during World War II.

The bleak budget outlook has reinvigorated the search for policies that could reduce the deficit substantially without imposing significant pain. Some have expressed the hope that more rapid economic growth could slay the deficit dragon. But most economists do not think the economy's long-run growth potential can be raised significantly without reducing consumption in the short run.

Moreover, even if this economy were to expand 1 percent a year faster than the Congressional Budget Office (CBO) has assumed—and that, I might stress, is a very unlikely prospect—the deficit would still total $230 billion in 1998. In other words, the problem would not go away.

Others have expressed the hope that health care reform might reduce spending sufficiently to bring down the deficit. Although reform of our health care system is probably an essential component to any long-run effort at reducing the deficit, the added costs that would be associated with improving access for the 35 million Americans who lack health insurance now and the need to reduce the disparity that exists between government and private reimbursement rates to providers are likely to eat up any budgetary savings that we might expect over the next 5 or 10 years.

The unpleasant truth is that there are no alternatives to cutting government programs that many regard as worthwhile and raising taxes that many regard as already excessive.

But we need to emphasize the fact that the sacrifices that are implicit in meaningful deficit reduction now will pay dividends in the future. If we were to adopt policies that would balance the budget over the next 5 or 10 years, which would involve, by the way, adjustments that are roughly twice as large as the ones we adopted in 1990 as part of the budget summit, sustainable living standards in the 21st century would be increased by more than 5 percent per capita.

In the short run, a substantial deficit reduction effort of this sort could dampen the growth rate of the economy by about one-half a percentage point a year for about 3 to 5 years. In other words, if we thought the growth rate was going to be 3 percent, it could be knocked down to around 2½ percent by the fiscal contraction associated with a deficit reduction effort of that magnitude.

But the good news is that CBO believes a more expansionary monetary policy could largely offset these fiscal effects. In other words, a more expansive policy from the Federal Reserve associated with a sharp fiscal contraction by the Congress and the President could offset each other.

Let me close by saying a few words about the role that the budget process can play in any deficit reduction effort. This is a relevant issue because the current budget process, the Budget Enforcement Act of 1990, is approaching the end of its useful life, and will have to be modified, extended, or allowed to expire.

The decade of experience that we have had with procedural reforms designed to achieve budgetary outcomes has taught us a number of lessons that I think should be considered when the future of the Budget Enforcement Act is debated, as I suspect it will be during this year.

The first of these lessons is that budgetary processes are more effective in enforcing decisions that have already been made than in forcing decisions sometime in the future. The Gramm-Rudman-Hollings era taught us that procedural requirements for future deficit reduction, even when they are enforced by seemingly automatic sanctions such as sequestration, cannot force policymakers to make decisions that they do not want to make.

The Budget Enforcement Act, on the other hand, fairly successfully ensured that the specific spending cuts and tax increases that were agreed to in 1990 were carried out. It was a device that kept the political system from backsliding. It did not force additional actions as the Gramm-Rudman-Hollings procedure attempted to do. It just put on a series of restraints, so what was agreed to could not be undone.

A second lesson of the past decade is that processes that hold participants accountable for the outcomes that are under their control are likely to be more effective than those that also hold participants responsible for developments beyond their control. Since the budget is buffeted by forces that are both unpredictable and beyond the control of policymakers, such as the economy, for one thing, or the weather, for another, some flexibility is essential if a budget process is going to survive.

The Budget Enforcement Act allowed for a good deal more flexibility than was allowed under the Gramm-Rudman procedures, and that was one reason why I believe it has worked as well as it has.

A final lesson learned over the past few years is that enforcement procedures must be credible to be effective. Sequestrations of 30 percent or 35 percent, as were called for in 1990 by the Budget Enforcement Act, are incredible and therefore ineffectual. Nobody believes they will take place, so nobody is cowed by such threats.

I urge you to keep these lessons in mind when you grapple with proposals to change the budget process. But above all, you must remember that process is not a substitute for real deficit reduction measures. Process cannot make such measures happen, nor can it do much to ease the political pain that is inevitably involved when taxes are raised or spending is cut.

That concludes my summary. I will be glad to answer any questions that the committee has.

[The prepared statement of Hon. Robert D. Reischauer follows:]

PREPARED STATEMENT OF HON. ROBERT D. REISCHAUER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Chairman and Members of the Budget Committee, I appreciate the invitation to review the economic and budget outlook with you at the start of a new Congress and a new Administration. Last week, the Congressional Budget Office (CBO) released the first volume of its annual report. The report assesses the state of the economy and updates CBO's budget projections. It also examines the economic consequences of reducing the budget deficit and the role of the budget process in enforcing a deficit reduction plan. My statement summarizes the conclusions of our report.

At long last, the U.S. economy seems to be entering a period of self-sustaining growth. But this expansion will differ from previous ones in two key respects. First, in 1993 and 1994, the economy will grow at only three-fourths of the pace that is typical for this stage of the business cycle. Second, the rate of growth will be insufficient to bring down the Federal budget deficit, which will hover near $300 billion for several years and will then grow even larger. Under current budgetary policies, the deficit will climb from $310 billion in 1993 to $357 billion in 1998 and about $650 billion in 2003.

Such lackluster expansion and large budget deficits are not merely coincidental. Living standards are projected to grow so slowly, in part, because of the decline in the national saving rate over the past decade. And the Federal budget deficit has been a major contributor to that drop in saving.

By the same token, reducing the deficit is the most direct and reliable way to increase national saving and long-run economic growth. Increasing the share of government spending devoted to investment could also spur growth, but the specific projects would have to be chosen carefully so that their benefits exceeded their costs. At first, efforts to eliminate the deficit would tend to weaken income and employment, but a more stimulative monetary policy could largely offset this disruption. Over the long run, a higher rate of saving would encourage new investment, boost workers' productivity, reduce net borrowing from abroad, and raise real incomes and living standards.

THE ECONOMIC OUTLOOK

Altough the economy reached the bottom of the recession in the first quarter of 1991, the first year of the recovery was extremely weak, and the unemployment rate continued to rise through mid-1992. In the summer of 1992, however, the economy appears to have turned a corner. Though still slow by historical standards, the rate of growth is likely to be enough to ensure that the unemployment rate will gradually decline without requiring further fiscal or monetary stimulus.

The Forecast for 1993 and 1994

CBO forecasts that real gross domestic product (GDP) will grow at an annual rate of 3 percent in 1993 and 1994. Although this increase is well below average for the start of an expansion, it will bring the unemployment rate down from 7.3 percent at the end of 1992 to below 6½ percent by the end of 1994.

CBO's economic forecast was prepared before the Commerce Department announced a 3.8 percent growth rate for the fourth quarter of 1992. When combined with the 3.4 percent figure for the third quarter, this rate makes CBO's forecast of 3 percent growth for this year seem pessimistic. It appears unlikely, however, that real consumption can continue to increase at the 4 percent pace of the last half of 1992, given the slow improvement in employment and real wage and salary income to date. Increases in consumption will probably ease as households rebuild their savings.

CBO does anticipate, however, that the recent rise in final sales will boost employment. Household employment increased by about 1.6 million between December 1991 and last December—an average of about 130,000 jobs per month—and the pace has picked up in recent months. Net job growth was slow relative to growth in output because of the usual early-expansion increase in productivity. Employment during 1993 will be helped both by the recent surge in final sales and by slower gains in productivity. Firms will find it progressively more difficult to meet demand by using their existing employees more intensively.

The growth forecast is mild by historical standards, and one benefit of such a tepid expansion is that inflation will remain low. Given the substantial excess capacity in the economy, the consumer price index should increase by only about 2¾ percent a year for the next few years. Interest rates are expected to remain nearly

constant through 1993, though short-term rates will rise during 1994, once the expansion is firmly established.

CBO's forecasts of economic growth and unemployment are close to those of the *Blue Chip* consensus of private forecasters (see Table 1). CBO is slightly more optimistic, however, about the prospects that low inflation and low short-term interest rates will continue. But even if CBO has underestimated inflation, the deficit projections would be little affected; although higher inflation would add slightly more to outlays than to revenues, the deficit would be no higher as a share of GDP.

The Role of Monetary Policy

The economic outlook is influenced by many factors, including monetary policy and other events in financial markets. Looking back over the past few years, including both the recession and the early recovery, it is clear that the Federal Reserve followed a cautious policy that has brought down the Federal funds rate roughly in line with where market forces put other short-term interest rates. This response is a contrast with other periods of recession and early expansion, when the Federal Reserve has often attempted to lead interest rates down rather than following the market. Some commentators are concerned that if this policy continues, it might keep the expansion slow.

CBO's forecast, prepared in December, did not assume any additional easing moves by the Federal Reserve, and given what we then knew, a continuation of the Federal Reserve's cautious policy, together with low inflation, seemed likely to allow real growth in the 3 percent range as we forecast. More recently, we have had some encouraging news on the state of the economy—especially reports of strong growth in the fourth quarter and good home sales in December. But the most widely watched measure of the money supply, M2, has shown little growth since last November. It is not clear whether this weakness in M2 reflects a weakness in the economy, which would require monetary action to offset, or some other factor that should not lead to additional monetary easing. As more indicators of the state of the economy in January become known, the Federal Reserve might take action to ensure adequate growth in M2.

Projections for 1995 Through 1998

CBO does not attempt to forecast cyclical fluctuations in the economy more than 2 years into the future. Thus, beyond 1994, the projections are based on trends in the labor force, productivity, and national saving.

Over the 1995–1998 period, CBO projects that real GDP will grow at an average annual rate of about 2½ percent (see Table 2). By comparison, potential output grows only 2 percent a year. The gap between actual and potential real GDP will therefore gradually shrink to its historical average of about 0.6 percent of potential GDP by 1998.

Because GDP remains below its potential throughout the period of the projections, inflation is not likely to rise. Long-term interest rates are also assumed to remain steady at about 6.5 percent, although short-term rates are projected to rise from 3.7 percent in 1994 to 4.9 percent by 1998.

The Budget Outlook

The onset of economic expansion will bring no relief from recordbreaking budget deficits. As CBO projected last summer, the Federal budget deficit is stuck near $300 billion for the next few years and will move even higher in the second half of the 1990's. If the current fiscal course is not changed, 10 years from now the deficit could reach twice today's level. Federal debt would then represent almost 80 percent of GDP, higher than at any time since the aftermath of World War II.

The Outlook for the Deficit

The Federal budget deficit set a record of $290 billion in 1992. CBO estimates that the 1993 deficit will be even higher—$310 billion, or 5 percent of GDP (see Table 3). An expanding economy is likely to keep the deficit in check for a few years, but by 1996 or 1997 upward pressures on the deficit will again come to the fore.

These baseline budget projections assume that current laws and policies affecting tax revenues and mandatory spending remain unchanged. Discretionary spending (that is, spending controlled by annual appropriations) in 1994 and 1995 is assumed to be held to the tight limits established in the Budget Enforcement Act of 1990 (BEA). These caps require that discretionary outlays be cut by roughly 7 percent in real terms between 1993 and 1995. CBO assumes that discretionary outlays will grow at the same pace as inflation after 1995.

One can see the rising trend in the deficit most clearly in the standardized-employment deficit, which removes the effects of the business cycle from government revenues and spending. CBO projects that the standardized-employment deficit will rise, with only one slight interruption, from $180 billion (3.1 percent of potential GDP) in 1991 to $351 billion (4.4 percent of GDP) in 1998.

Why this grim budget outlook? After all, revenues are projected to keep pace with GDP, and most major spending programs are projected to grow no faster than the economy. However, the costs of the two major health care entitlements—medicare and medicaid—are expected to continue to explode. Together, medicare and medicaid benefits represented 3.4 percent of GDP in 1992, but they are projected to swell to 5.1 percent of GDP by 1998. The runaway growth in these programs parallels the projected growth of 10 percent a year in national health expenditures and stems largely from continued increases in the cost and use of medical care. Health care reform is currently high on the public policy agenda. But reform will almost certainly entail using public resources to extend health insurance coverage to the 35 million Americans who are now uninsured, as well as controlling health care costs. It will prove difficult, therefore, to reduce Federal health costs significantly.

More rapid economic growth is also not going to slay the deficit dragon. Even if the economy were to expand 1 percent a year more rapidly than CBO assumes—an unlikely outcome—the deficit would still total $230 billion in 1998.

Chances in the Projections

The outlook for the 1993 deficit has brightened a bit since CBO's previous budget projections last summer, but the longer-term fiscal picture has dimmed. The revisions to the projections have nothing to do with recent legislation, which on balance has had a negligible effect on the deficit. Nor do the revisions stem from CBO's updated economic assumptions, which worsen the deficit through 1995 but improve it thereafter. The culprit is changes in other, so-called technical factors that determine revenues and spending (see Table 4).

In 1993, the largest technical reestimate is a reduction of $45 billion in projected spending for deposit insurance. That shortfall is largely the result of a delay in providing necessary funds to the Resolution Trust Corporation (RTC), the agency charged with closing or merging hundreds of insolvent savings and loan institutions. But it also reflects a modest reduction in CBO's estimate of the long-run cost of resolving troubled thrift institutions and banks, as well as a decrease in RTC's estimated need for working capital. Therefore, only part of the lower spending in 1993 is projected to be made up in the next few years.

In 1994 and beyond, higher medicare and medicaid spending dominates the technical reestimates. Although CBO has upped its projections for these two programs several times in the past few years, actual spending continues to outpace the estimates. In medicare, the most rapid increases have been for care at home and in skilled nursing facilities. The growth in medicaid is fueled by unexpected increases in the number of aged and disabled beneficiaries.

Comparison with the Bush Administration's Projections

The Bush Administration published its own baseline budget projections on January 6. Compared with the CBO baseline, the Bush Administration's projections are marked by similar deficits in 1993 through 1995 but lower deficits in the 1996–1998 period. On balance, most of the difference in the later years can be ascribed to different assumptions about the path of discretionary spending (see Table 5). Economic and technical estimating differences are largely offsetting.

Both the CBO and Bush baselines assume that policymakers will abide by the BEA's discretionary spending caps through 1995, but they make sharply different assumptions thereafter. The CBO baseline assumes that total discretionary spending will grow at the rate of inflation after the caps expire. The Bush Administration's projections, however, assume that discretionary spending will remain frozen at 1995's dollar level. This single difference in baseline concepts trims the Bush Administration's projected deficits by $16 billion in 1996, $32 billion in 1997, and $50 billion in 1998.

The Challenge of Reducing the Deficit

Large and growing budget deficits have been a problem for a decade, and there have been many stabs at a solution. Most recently, in the 1990 budget summit agreement, the Congress and President Bush adopted a package of tax increases and spending reductions totaling almost $500 billion over 5 years, as well as a set of budgetary procedures designed to assure that subsequent legislation would not erode those savings. Because the 1990 package has proved insufficient, and now that the

economy has resumed growing, reducing the deficit is rightly receiving renewed attention.

The problem today, however, is bigger than it was in 1990. Another 5-year, $500 billion effort would not quite halve the deficit by 1998. Eliminating the deficit over the next 5 years would require tax hikes and spending cuts about twice as large as those adopted in 1990.

The Economic Consequences of Reducing the Deficit

CBO has analyzed the probable effects of reducing the deficit using several macroeconomic models. Even though the models differ considerably in design, they reach broadly similar conclusions.

First, closing the deficit or increasing the share of government spending that goes to productive investment would increase the standard of living that will be sustainable in the 21st century. A reasonable estimate is that eliminating the deficit would eventually increase consumption per person by more than 5 percent.

Second, efforts to reduce the deficit would tend to dampen economic activity and increase unemployment in the next few years, but a more expansionary monetary policy could largely offset these fiscal effects. Even if the monetary stimulus were not fully offsetting, a planned steady reduction in the deficit should not throw the economy back into recession, as long as the economy is growing at the moderate rate that is projected.

Third, whether the deficit is closed in 5 years or 10 years makes little difference to the economy in either the short or long run, provided that the effort is credible and is carried through. Because much of the expected rise in the deficit occurs after 1998, a program to balance the budget in 10 years would come close to its goal after 5 years as well. In either case, the more credible the effort, the more likely that the Federal Reserve will provide the necessary monetary boost, and the more likely that private investment will rapidly fill the gap left by lower public and private consumption.

The Budget Process and Deficit Reduction

How might changes in the budget process make deficit reduction more credible? Before 1985, the laws governing the President's budgetary submission and the rules concerning Congressional consideration of the budget prescribed formats and procedures, not outcomes. In recent years, however, there have been three efforts to construct a budget process that would achieve a specific result—namely, a lower deficit.

The first two attempts—the Gramm-Rudman-Hollings legislation of 1985 and 1987—established fixed numerical targets for the deficit and aimed to balance the budget in 5 years. But each time, a deteriorating economic outlook and changes in other factors led the deficit to grow more rapidly than expected and made the political burden of meeting the targets impossible to bear. The new budgetary procedure therefore proved incapable of forcing the President and the Congress to agree on the substantial tax increases or spending cuts that were needed to meet the deficit targets. Instead, policymakers turned to budgetary gimmickry and unrealistic assumptions to avoid the strictures of the law.

The Budget Enforcement Act of 1990 scrapped much of Gramm-Rudman-Hollings. It replaced the previous focus on fixed deficit targets with a concentration on enforcing the $500 billion of deficit reduction that had been adopted at the budget summit. The BEA set up two major enforcement mechanisms—annual limits on discretionary appropriations and a pay-as-you-go requirement for revenues and mandatory spending. These procedures have succeeded in preventing new legislation from making the deficit worse, even though economic and technical factors have again caused a substantial increase in the projected deficits.

The experience of the past 7 years suggests that the chances of reducing the deficit will be enhanced if attention is focused on policy first, process second. Once the Congress and the President have agreed on specific spending cuts and tax increases, then they should put in place a process to ensure that those measures are carried out. At a minimum, this process should include giving the discretionary spending limits and pay-as-you-go procedures in the BEA a new lease on life.

Reducing the Deficit Versus Increasing Government Investment

Although my testimony has focused on the effects of eliminating the Federal Government's deficit, the economy could gain a similar long-term improvement if the government's spending on consumption could be reduced and its spending on well-chosen investments increased. Both strategies would shift resources from consumption to saving and investment and thus increase the level of living standards attainable in the long run.

A strategy of shifting government spending from consumption to investment has the advantage that it need not, if the shift is carefully managed, weaken the economy in the short run. Some industries would be hurt and others helped, as is always the case when the government's policies change, but these effects could be arranged to cancel themselves out roughly in the economy as a whole.

Across-the-board increases in public investment, however, are unlikely to boost greatly the productive capacity of the economy. Only if government investment choices are based on economic criteria—that is, they meet the ordinary standards of cost-benefit analysis—can they be expected to be as productive as private investments. Finding and evaluating such valuable investments take time, so the scope for sharp increases in national saving investment by that route is likely to be limited.

Conclusion

As was widely expected in 1990, when the Budget Enforcement Act was adopted, deficit reduction is likely to return to the top of the political agenda in 1993. At least three factors increase the chances of action this year. First, the public debt will reach its statutory limit in March, and the need to increase the limit may again force a revision of the budget process, as it did in 1985, 1987, and 1990. Second, the President and the Congress may desire some flexibility in meeting the discretionary spending limits, which are pinching more tightly. Third, the pay-as-you-go rule could use strengthening; because this requirement is scheduled to expire in only 2 years, it is becoming relatively easy to shift costly programs beyond the reach of the BEA's enforcement arm.

Although these factors can set the stage for deficit reduction, they cannot make it happen, nor will they ease the political choices. The deficit will come down only when both elected officials and the public conclude that the borrowing binge must stop. They must be willing to pay higher taxes and receive fewer government benefits in the 1990's for the sake of higher living standards in the next century.

Table 1.
Comparison of Forecasts for 1993 and 1994

	Actual 1991	Estimated 1992	Forecast 1993	Forecast 1994
	Fourth Quarter to Fourth Quarter (Percentage change)			
Nominal GDP				
CBO	3.5	5.1	5.4	5.4
Blue Chip	3.5	5.3	6.0	6.4
Real GDP[a]				
CBO	0.1	2.7	2.8	3.0
Blue Chip	0.1	2.7	3.0	3.2
Implicit GDP Deflator				
CBO	3.4	2.4	2.5	2.4
Blue Chip	3.4	2.6	2.9	3.1
Consumer Price Index[b]				
CBO	3.0	3.1	2.8	2.7
Blue Chip	3.0	3.0	3.2	3.6
	Calendar-Year Averages (Percent)			
Civilian Unemployment Rate				
CBO	6.8	7.4	7.1	6.6
Blue Chip	6.8	7.4	7.0	6.5
Three-Month Treasury Bill Rate				
CBO	5.4	3.5	3.1	3.7
Blue Chip	5.4	3.5	3.5	4.2
Ten-Year Treasury Note Rate				
CBO	7.9	7.0	6.7	6.6
Blue Chip[c]	7.9	7.0	6.9	7.2

SOURCES: Congressional Budget Office; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators;* Department of Commerce, Bureau of Economic Analysis.

NOTE: The *Blue Chip* forecasts through 1994 are based on a survey of 50 private forecasters, published on January 10, 1993.

a. In constant 1987 dollars.

b. The consumer price index for all urban consumers (CPI-U).

c. *Blue Chip* does not project a 10-year note rate. The values shown here for the 10-year note rate are based on the *Blue Chip* projections of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 10-year Treasury notes.

Table 2.
Medium-Term Economic Projections (By calendar year)

	Estimated 1992	Forecast 1993	Forecast 1994	Projected 1995	Projected 1996	Projected 1997	Projected 1998
Nominal GDP (Billions of dollars)	5,943	6,255	6,594	6,942	7,288	7,627	7,953
Real GDP (Billions of 1987 dollars)	4,918	5,054	5,204	5,354	5,497	5,628	5,740
Real GDP (Percentage change)	2.0	2.8	3.0	2.9	2.7	2.4	2.0
Implicit GDP Deflator (Percentage change)	2.6	2.4	2.4	2.3	2.3	2.2	2.2
CPI-U (Percentage change)	3.1	3.0	2.7	2.7	2.7	2.7	2.7
Unemployment Rate (Percent)	7.4	7.1	6.6	6.2	6.0	5.8	5.7
Three-Month Treasury Bill Rate (Percent)	3.5	3.1	3.7	4.4	4.7	4.8	4.9
Ten-Year Treasury Note Rate (Percent)	7.0	6.7	6.6	6.6	6.5	6.5	6.4

SOURCE: Congressional Budget Office.

NOTE: CPI-U is the consumer price index for all urban consumers.

Table 3.
CBO Deficit Projections (By fiscal year)

	1991	1992	1993	1994	1995	1996	1997	1998
				In Billions of Dollars				
Total Deficit	270	290	310	291	284	287	319	357
Standardized-Employment Deficit[a]	180	201	228	222	230	256	309	351
Deficit Excluding Social Security and Postal Service	322	340	361	347	351	364	402	445
				As a Percentage of GDP				
Total Deficit	4.8	4.9	5.0	4.5	4.1	4.0	4.2	4.5
Standardized-Employment Deficit[a, b]	3.1	3.3	3.6	3.3	3.3	3.5	4.1	4.4
Deficit Excluding Social Security and Postal Service	5.7	5.8	5.9	5.3	5.1	5.1	5.3	5.7
Memorandum: Gross Domestic Product (Billions of dollars)	5,633	5,869	6,173	6,508	6,855	7,202	7,543	7,873

SOURCE: Congressional Budget Office.

a. Excludes cyclical deficit as well as deposit insurance and Desert Storm contributions.

b. Shown as a percentage of potential GDP.

Table 4.
Changes in CBO Deficit Projections (By fiscal year, in billions of dollars)

	1993	1994	1995	1996	1997
Summer Baseline Deficit	331	268	244	254	290
Changes					
Policy changes	1	1	a	a	a
Economic assumptions					
Revenues[b]	15	23	27	28	36
Net interest	-5	-12	-15	-17	-20
Other outlays	a	-1	-7	-17	-29
Subtotal	9	10	6	-6	-13
Technical reestimates					
Revenues[b]	6	4	5	6	5
Deposit insurance[c]	-45	-5	8	8	4
Medicaid	2	5	8	10	12
Medicare	a	5	8	11	14
Other major benefits	3	2	2	2	3
Net interest[c]	-2	-4	-1	1	3
Other outlays	6	4	4	a	a
Subtotal	-30	11	34	37	42
Total Changes	-21	23	40	32	29
Winter Baseline Deficit	310	291	284	287	319

SOURCE: Congressional Budget Office.

a. Less than $500 million.

b. Revenue losses are shown with a positive sign because they increase the deficit.

c. Excludes changes in interest paid by deposit insurance agencies to the Treasury. These interest payments are intrabudgetary and do not affect the deficit.

Table 5.
Comparison of the Bush Administration's and CBO's Deficit Projections
(By fiscal year, in billions of dollars)

	1993	1994	1995	1996	1997	1998
CBO Baseline Deficit	310	291	284	287	319	357
Conceptual Differences						
Discretionary spending	n.a.	-1	-1	-15	-30	-45
Net interest	n.a.	a	a	-1	-2	-4
Subtotal	n.a.	-1	-1	-16	-32	-50
Economic Differences						
Revenues[b]	-5	-17	-23	-33	-48	-75
Benefit programs	a	1	6	13	21	30
Net interest	2	8	12	12	14	14
Subtotal	-3	-8	-5	-7	-13	-31
Technical Differences						
Revenues[b]	a	2	8	11	22	33
Deposit insurance	13	6	-18	-14	2	3
Net interest	3	2	1	1	4	7
Other outlays	4	a	3	5	2	a
Subtotal	21	11	-6	2	30	43
Total Differences	17	1	-11	-20	-14	-38
Bush Administration Baseline Deficit	327	292	272	266	305	320

SOURCES: Office of Management and Budget, Congressional Budget Office.

NOTE: n.a. = not applicable.

a. Less than $500 million.

b. Larger revenues are shown with a negative sign because they reduce the deficit.

Chairman SABO. Thank you, Dr. Reischauer.

We are privileged to have with us today a member of this committee, the Majority Leader. I would yield the floor to him.

Mr. GEPHARDT. Thank you, Mr. Chairman.

Dr. Reischauer, we deeply appreciate your testimony and the work that you do and your staff does. I think it is always unfailingly good work and helpful analysis and forecasting for us on the Budget Committee and for the entire Congress.

I remember working with you closely in the 1990 budget summit and felt that you were immeasurably helpful to us in putting together that product. And we obviously look forward to working with you as we face the challenges of this budget and this committee program for 1994 and beyond.

Your report today unhappily forecasts a worsening deficit that by 1998 will reach about $350 billion or so. The deficit, as you say, is a horrible drag on our national savings rate, on our living standards, and average Americans are being stifled by both.

Coming out of the recession, two-earner family income declined 1.6 percent and single-family income dropped an average of 4.8 percent. And we all know that jobless Americans face unemployment lines with only a moderate improvement in work force predicted by year's end.

And we all know that if we can reduce unemployment by just 1 percentage point in 1993, we could reduce the deficit by $50 billion.

Americans endured the recession trying to hold on to their jobs, and many who didn't lost their jobs, depleted their savings, lost their health care benefits or even their homes.

On November the 3rd, I think the American people sent a message to all of us that they would no longer tolerate doing nothing to address the economy, inaction on the jobless situation, broken promises on runaway deficits, and unaffordable, if not unattainable, health insurance.

Two weeks from today the President will address a Joint Session of Congress and the Nation with his plan to set these things right. I believe his plan will be bold and comprehensive.

He will propose real deficit reduction along with both economic stimulus and long-term human and physical infrastructure investment. He will propose private investment incentives that will spur economic activity in sectors that have been stagnant for too long. And shortly, in May, he will propose comprehensive health care reform which will attack out-of-control costs and access for the uninsured.

Elements of this bold initiative will surely be criticized from all quarters. It will require all of us to make compromise on issues which run against our beliefs.

As this committee begins the debate on the budget resolution, I would ask that we consider the merits of this plan in its totality and not fixate or overfocus on any one part of it.

Until these tough issues in the budget are addressed, we cannot hope to move affirmatively on an economic program that has any chance of making things better for average Americans. The budget plan is a means to an end in our endeavor to create the kind of economy that will sustain the American dream.

I also want to say to our friends on the other side that from my viewpoint, and I think from the President's viewpoint, we want an active dialogue with all of the Members of Congress. This will not be a plan that is meant for Democrats only. It is a plan that we hope to attract Republican support for as well. And we encourage your input and your honest dialogue as we try to get the votes together to pass what I think will be a very important step for the future of our country.

Thank you.

Chairman SABO. Thank you.

Mr. Kasich?

Mr. KASICH. Thank you.

Let me say to the Majority Leader, I am not sure if you borrowed that speech from Bill Frenzel or Bill Gradison, because we heard the same feelings when we were having to defend the budget document as it came from the White House. We do look forward to working together, trying to participate in solving this problem.

Dr. Reischauer, I would just like to get quickly into two areas. I wondered if you have done any study in this area. The Congress raised taxes in 1982. We were supposed to have *X* number of spending cuts for every dollar of tax increase. And then in the Reagan years, in 1986, we had another revenue increase, and then of course in 1990 we had another tax increase that was designed to reduce deficits and bring about spending cuts.

As I observe the process, I have come to the conclusion that Congress finds it very easy to raise taxes and very difficult to follow through with the restraint of government, the spending cuts. And the reason I say that is that the three times we have put plans together, we were real quick to raise the taxes but never followed through with the spending cuts.

Two things. Why is it that we now hear that the only solution involves taxes, and that somehow the tough choice is to raise taxes when we seem to always do it and yet not make the spending cuts? We have not followed through with any of our promises. Why don't we just postpone any talk about revenues until we can begin to face the tough decisions?

What I guess I am saying to you, Doctor, is that whenever we raise taxes, whenever we raise revenue, it allows us to put off stopping the arterial bleeding that is occurring in our Federal Government. We never reduce the overhead. It would be like a business that just says we can keep raising prices and we don't have to downsize.

Why is it that business can downsize and government cannot? And why is it I hear a constant advocating of tax increases to solve this problem when we have yet to come to grips with the overhead of government?

Dr. REISCHAUER. If I knew the answer to that, I would be able to solve the problems that face the Nation right now.

Let me go back and comment on your opening discussion. In 1981 the Congress cut taxes substantially. In 1982 some of the tax cuts that were called for in the 1981 legislation were clawed back.

The 1986 legislation was designed to be basically revenue neutral. It was changing components in the tax system, raising taxes on corporations, lowering them on individuals, changing the rate

structure for individuals, but it was intended to be basically revenue neutral.

You are correct that the 1990 Omnibus Reconciliation Act raised taxes in an effort to bring down the deficit. If that package remains the same—and there are several more years to go—it should reduce deficits from what they would have been by about $480 billion over the 1990–1995 period.

Our estimates suggest that most of that saving is actually going to come on the spending side; that only a third—32.7 percent of it—is attributable to higher revenues; that a lot of it is going to appear in the form of spending reductions in the discretionary area, which is the problem that the Congress has been grappling with for the last couple of years.

Most of that saving, of course, is in defense. We are very fortunate that the Soviet Union fell apart just as the United States was required to make substantial discretionary spending cuts. But I think it would be wrong to say that you have not cut back spending from where it would have been otherwise.

Mandatory spending—particularly the big health programs, medicare and medicaid—has been going up like gangbusters. Very small reductions were made in medicare as part of the 1990 summit agreement. But those have been swamped by the built-in increases in that program.

Mr. KASICH. One thing that confuses me, Doctor, we did give big increases to the base in the nondefense discretionary spending, and basically you are confirming what I said. The only area we have made any cuts in has been defense. Of course, if you come from California, and half the people in your district are out of work because of cuts in defense, it is painful. But the only area that we have been willing to cut has been defense, not entitlements, not the discretionary programs.

But yet when I read the newspaper——

Dr. REISCHAUER. Domestic discretionary programs.

Mr. KASICH. That is right. When I read the newspaper I am constantly faced with this argument that if we don't raise taxes, we can't have serious deficit reduction. I am confused about that. We have raised these taxes in the 10 years I have been watching Congress at least twice, and I argue three times, but we never cut the spending.

So why don't we cut the spending first and why don't we start advocating reducing overhead and downsizing for 2 or 3 or 4 years before we raise revenues? Why do you have to make the argument that in order for it to be serious, we have got to raise taxes?

Dr. REISCHAUER. I haven't made that argument. I am neutral about whether you raise taxes or cut spending or do a combination of both.

All I would say is that the part of the budget that you are talking about is a little bit over $200 billion. Total spending is going to be close to $1.5 trillion. Much of that $200 billion goes for the nuts and bolts, the institutional infrastructure that keeps society going.

Mr. KASICH. I am saying the only thing that we have reduced since my time in Congress has been defense because there is not a constituency for it unless your workers are out of work. That is the

only thing that restrained defense and it didn't restrain it well. Taxes went up, entitlements and discretionary went up.

I am saying, why can't we bring the others down before we start to raise taxes again?

Dr. REISCHAUER. You have shaved a bit off of the social security system; you have cut back a bit in the farm price-support programs; you have cut back a bit in Federal retirement programs; you have cut back a good deal in medicare. Have you cut enough, proportionate to what these spending items count in the budget? No, certainly not.

Mr. KASICH. The last area I want to ask about quickly, Doctor, because I don't want to take too much time, but here we have some economic statistics that came out this morning that indicates the leading economic indicator is up 1.9 percent in December, the largest increase since 1983. New home sales climbed 6.3 percent, GNP grew at 6.8 percent.

We have a $6 trillion economy. Why do we need $16 to $20 to $30 billion on some kind of stimulus package? First of all, does it help to raise the deficit further today in light of the fact we are running big deficits and they are what you are talking about today?

Secondly, can a $20 to $30 billion stimulus package have an impact on growth in this economy when you consider that at $6 trillion, and in addition to the fact that a study could indicate that a lot of this money would be distributed on a political basis?

I wondered if you think we should go forward with any kind of a stimulus package or use this money to reduce the deficit.

Dr. REISCHAUER. This is a judgment call for you to make, not for me. If you believe, as we do, that the economy is going to grow at about 3 percent over the next couple of years, you have to ask yourself, do we want to have a slightly faster growth rate in the short run? Do we want to increase it with a package such as the one that you are talking about—$20 to $30 billion—maybe three-tenths of a percentage point, maybe four-tenths of a percentage point, that order of magnitude? In other words, not a great deal. That is a difficult call.

If one were to say that what is needed is some short-run stimulus to sweeten the bitter deficit reduction pill that you are going to be asked to swallow, you might view the desirability of this package differently.

But right now, the question comes down to how uncertain are you about that 3 percent growth? If you thought the growth had a good chance of slipping down to 2 percent, you might think differently about the desirability of a stimulus package to provide insurance that we don't have slow growth.

The consensus of economists is quite narrow. There are few people who think growth is going to be below 2.5 percent. The vast majority thinks that we will have growth above 2.5 percent, or around 3 percent. So as I said, it is a judgment for you to make.

Mr. KASICH. Thank you.

Chairman SABO. Dr. Reischauer, to help us understand what happens with the budget and with deficit projections, last year when you were here, the CBO projections for 1997 was a deficit of about $226 billion. It is now projected at $319 billion, or close to a $100 billion increase from a year ago.

And to the best of my recollection, no fundamental policy changes occurred in the last year. As it related to discretionary spending, the Congress met the targets of the 1990 budget agreement. As a matter of fact, I think in budget authority we are $15 to $16 billion below those 1990 budget targets. No significant changes made in policy as it related to entitlement programs in 1992. Yet, the difference in the deficit has grown by $90 to $100 billion.

Could you tell us what is changed?

Dr. REISCHAUER. I do not think that is a comparison of our last forecast.

Chairman SABO. From a year ago, not from August. Not from August. January of a year ago.

Dr. REISCHAUER. I do not have a breakdown for a year ago. The ever-helpful staff gives me two pages I am supposed to add together.

Chairman SABO. I am right when I say that that change has not occurred by policy decisions. By the then administration——

Dr. REISCHAUER. The policy decisions that have been enacted over the last year have changed the 1997 budget deficit estimate by less than $1 billion. In other words, this is sort of a rounding error. This is noise. You can ignore that completely.

The economic assumptions—the changes in how the Congressional Budget Office (CBO) views the economy in 1997 now as opposed to how we viewed it a year ago—have increased the deficit by $8 billion.

So the problem is not largely an economic one. What is the problem? It is called technical reestimates. And the technical reestimates have raised the deficit by $86 billion.

Now, where is the real problem with respect to technical estimates? One area is deposit insurance, the savings and loan or bank bailouts. CBO's estimates of that have changed substantially, strengthening the fundamental condition of the banks offset by the delay in providing the Resolution Trust Corporation (RTC) money.

Chairman SABO. Let me follow up a little bit. Does that impact the 1997 deficit projection?

My understanding always was that there might be some switch from 1993 to 1994 depending on what funding was required. But is it for 1997 for a projection of problems——

Dr. REISCHAUER. It plays out over a number of years, because the activity that was expected to occur in the RTC last year and this year, namely closing institutions, spending a lot of money resolving them, and accumulating a lot of assets that would be sold in future years, does not occur. It gets pushed off a couple of years.

In CBO's estimates, the deposit insurance numbers push up the deficit estimate by $15 billion in 1997. In other words, we are going to be selling fewer assets then. If we sold the assets, it would have lowered the deficit, but that will not occur. It is going to dribble out over a lot longer period of time, CBO thinks, and the amount of assets accumulated by the RTC will probably be somewhat lower than we expected a year ago.

Chairman SABO. And this reflects the old problem now to reestimate the new problems——

Dr. REISCHAUER. Correct. One has to realize that in this area of the budget—how much the savings and loan fiasco and the bank

problem are going to cost the American taxpayer—CBO and the Office of Management and Budget (OMB) and everybody are flying blind. There is not a lot of reliable data to go on. These are estimates surrounded by a wide range of uncertainty.

In addition, the culprits that we want to focus on are medicare, medicaid, and the other major benefit programs. Roughly $43 billion has been added to our estimate of the deficit because we think medicare, medicaid, and the other major benefit programs, including food stamps, are going to cost more than we thought.

What is going on here? It isn't that the structure of these programs has changed. But spending on medicare and medicaid, particularly for disabled adults and adults who are receiving home health care under part A of the medicare system, has been increasing at an extremely rapid rate, much more than CBO or OMB expected.

In part, this growth is being driven by court decisions that have come down over the last few years—court decisions that are requiring States to reimburse providers at more equitable rates in the medicaid program; court decisions that have told the Social Security Administration that it has to provide benefits to a group of disabled children to whom it had been denying benefits to in the past.

There is no way for budgeteers—green eye-shade folks—to first, guess how the judicial system is going to resolve some of those issues, and second, make good estimates of the impact that the court decision will have; how long it will take for, let's say, the disabled children and some of the disabled adults to be brought into the disability program and to be covered by medicare.

But as you pointed out, the benefit programs are all mandatory, and the deposit insurance accounts really involve no policy change. These are forces of change that buffet the budget, like the weather affects a farmer.

Speaking of the weather, we had tremendously good weather in the corn belt this year, and that produced a bumper crop of corn, driving down corn prices and increasing Commodity Credit Corporation (CCC) payments. The same thing happened to a lesser degree in wheat and cotton. And these are just some of the uncontrollable forces that buffet the budget. They are forces over which policymakers have very little control.

Chairman SABO. I am told there is about $30 billion left. Are there any other big categories there?

Dr. REISCHAUER. There are some revenue changes. There is a debt service component, of course. When you increase spending, the debt accumulated over this period rises, and you obviously have higher interest costs in the final year; you have to add those in.

Chairman SABO. Just so we have a good understanding on it, would you give us for the record in a form that we can rather quickly distribute to members of the committee a written description of what happened from January to February, I guess the period——

Dr. REISCHAUER. We will be glad to.

Chairman SABO. I think that would be useful.

[The material referred to follows:]

The following tables detail the changes between CBO's January 1992 and January 1993 budget estimates. The first table is a summary table showing the policy, eco-

nomic, and technical changes in CBO's deficit projection. The second table details changes in estimates of the cost of major benefit programs. An explanation of the reasons for the technical reestimates for these major benefit programs is also included. Finally, there is a table reflecting the changes in CBO's projections by source and an explanation of the reasons for those changes.

CHANGE IN CBO DEFICIT PROJECTIONS, JANUARY 1992 TO JANUARY 1993
(By fiscal year, in billions of dollars)

03-Feb-93	1993	1994	1995	1996	1997
January 1992 projection	327	260	194	178	226
Policy Changes					
Revenues	5	a	a	1	1
Outlays	5	2	1	1	a
Deficit	1	2	1	-1	-1
Economic Changes					
Revenues	-26	-36	-38	-45	-66
Outlays					
Net interest	-17	-22	-20	-19	-20
Other outlays	a	-4	-12	-25	-39
Subtotal	-16	-27	-32	-44	-59
Deficit	10	10	6	1	8
Technical Changes					
Revenues	-14	-12	-13	-15	-13
Outlays					
Deposit insurance b/	-61	-18	32	46	15
Medicare	5	10	15	19	23
Medicaid	1	5	8	10	12
Other major benefits c/	8	7	7	7	8
Net interest b/	-2	-4	a	6	12
Other	8	7	9	5	4
Subtotal	-41	8	70	93	74
Deficit	-27	19	83	108	86
Total Changes					
Revenues	-36	-47	-51	-59	-78
Outlays	-52	-16	39	49	15
Deficit	-16	31	90	108	93
January 1993 projection	310	291	284	287	319

SOURCE: Congressional Budget Office.

a. Less than $500 million.
b. Excludes interest paid by the deposit insurance agencies to the Treasury. These payments are intrabudgetary and do not affect the deficit.
c. Includes unemployment insurance, food stamps, family support payments, Supplemental Security Income, student loans, and Social Security.

CHANGES IN ESTIMATES OF MAJOR BENEFIT PROGRAMS, 1/92 TO 1/93 (billions of dollar

	1993	1994	1995	1996	1997
Medicare (function 570) a/					
Economic	-0.7	-1.5	-2.6	-4.4	-6.6
Technical	4.8	10.0	15.0	19.2	22.7
Legislative	0.0	0.0	0.0	0.0	0.0
Total	4.1	8.5	12.3	14.7	16.1
Medicaid					
Economic	-0.8	-1.9	-3.2	-4.9	-7.0
Technical	1.5	4.6	8.0	10.1	11.8
Legislative	0.0	0.0	0.0	0.0	0.0
Total	0.7	2.7	4.7	5.2	4.9
Family support & AFDC work					
Economic	0.2	0.3	0.2	0.1	0.1
Technical	0.1	0.1	-0.1	-0.0	-0.1
Legislative	0.0	0.0	0.0	0.0	0.0
Total	0.3	0.4	0.1	0.1	-0.0
Food stamps					
Economic	-0.3	-0.2	-0.7	-1.0	-1.4
Technical	1.8	2.1	1.8	1.6	1.8
Legislative	0.4	0.0	0.0	0.0	0.0
Total	2.0	1.9	1.1	0.6	0.4
Student loans					
Economic	-0.3	-0.5	-0.4	-0.3	-0.3
Technical	0.5	0.6	0.2	0.1	0.2
Legislative	-0.2	0.0	0.0	0.0	0.0
Total	0.0	0.1	-0.2	-0.2	-0.1
Social Security (function 650)					
Economic	-0.4	-2.1	-4.9	-8.2	-11.6
Technical	2.0	3.3	4.3	4.9	5.3
Legislative	0.0	0.0	0.0	-0.0	-0.0
Total	1.6	1.2	-0.5	-3.3	-6.4
SSI					
Economic	-0.0	-0.2	-0.3	-0.4	-0.7
Technical	2.4	2.5	2.6	2.8	3.5
Legislative	0.1	0.1	0.1	0.1	0.1
Total	2.4	2.5	2.4	2.5	2.9
Unemployment insurance (subfunction 603)					
Economic	2.4	1.5	1.2	0.6	0.3
Technical	0.9	-1.3	-2.0	-2.1	-2.1
Legislative	4.0	0.6	0.3	0.1	0.1
Total	7.3	0.8	-0.5	-1.4	-1.7
Total major benefits					
Economic	0.1	-4.6	-10.7	-18.6	-27.1
Technical	13.9	21.9	29.8	36.6	43.1
Legislative	4.3	0.8	0.5	0.2	0.1
Total	18.3	18.0	19.6	18.2	16.1
a. Medicare detail:					
Hospital Insurance	6.4	8.7	10.7	11.7	12.1
Supplementary Medical Insurance	-2.2	0.1	2.0	3.4	4.2
Premiums	-0.2	-0.3	-0.3	-0.3	-0.1
Total	4.1	8.5	12.3	14.7	16.1

Includes (relatively small) amounts of discretionary spending in certain prograr

Technical Reestimates

Medicare - Most of the reestimates have been in the Hospital Insurance program. The largest increase has been in the projections of spending for home health services. The reestimate is based on recently released data from the Health Care Financing Administration (HCFA) showing a surge in home health expenditures. Reimbursements for home health services have exploded during the past several years following a 1988 court decision liberalizing the benefit. Spending for skilled nursing facilities(SNF) has also exceeded expectations. In 1988, HCFA issued a new manual detailing eligibility rules. In 1989, the SNF benefit was changed by the Medicare Catastrophic Insurance Act of 1988. SNF spending surged. The new SNF benefit, however, was repealed in 1989, effective in 1990. SNF spending was expected to moderate with the repeal of the 1988 Act, but recent information shows continued rapid growth in SNF spending. Finally, recent information shows higher admission rates to hospitals and hospices than was anticipated in previous estimates.

Medicaid - Estimated enrollment in Medicaid in 1993 is up by 1.7 million over the number estimated a year ago, and expected enrollment in 1997 is up by 3.5 million over last year's estimate. Enrollment estimates are up for all categories of Medicaid enrollees, with the largest increases among the aged and disabled recipients. These two recipient categories are particularly important for costs because they have significantly higher per capita costs than the third major category of Medicaid recipients, families with dependent children. The increase in disabled enrollment is partially attributable to an increase in disabled children receiving benefits as a result of the Sullivan v. Zebley Supreme Court decision in February 1990, in which the Court ruled that the Department of Health and Human Services was applying a standard of disability for Supplemental Security Income (SSI) to children that was stricter than had been intended by Congress. Recently, DHHS has issued new regulations for evaluating childhood disability, and both the number of applications and the percentage of applications that are approved for SSI have increased. SSI recipients are automatically eligible for Medicaid. The projected increase in aged recipients reflects recent data and an improved estimating methodology.

Other Major Benefits - Upward reestimates in this category are primarily from Social Security, Supplemental Security Income (SSI) and Food Stamps. We have revised upward our projections of disabled Social Security and SSI recipients. In recent years, CBO's projected growth in the number of disabled persons receiving benefits has been consistently low. The CBO projections have typically assumed that the growth in caseload would subside. However, each year the number of Disability Insurance (DI) and SSI recipients has grown more rapidly than in the previous year. Increases in applications and allowance rates as well as decreased rates of terminations have all contributed. As mentioned, the Zebley case has also had an important impact on disabled children in SSI. Finally, the number of Food Stamp recipients has also exceeded CBO projections. While the projections did show Food Stamps recipients rising with increases in the unemployment rate, the actual increase has been well above that projected. The upward reestimates in this category have been partially offset by downward reestimates in the unemployment insurance program. Payments in the regular unemployment insurance program have been running somewhat below projected levels.

Differences Between CBO January 1992 and January 1993 Baseline Revenue Estimates, By Source
(By fiscal year, in billions of dollars)

	1993	1994	1995	1996	1997
		ECONOMIC DIFFERENCES			
TOTAL	-26	-36	-38	-45	-66
Individual Income	-16	-22	-24	-29	-44
Corporate Income	2	2	4	6	8
Social Insurance	-10	-14	-15	-20	-28
Excises	-*	*	*	-*	-*
Estate & Gift	0	0	0	0	0
Customs Duties	*	*	*	*	-*
Miscellaneous: Fed	-3	-3	-3	-2	-3
Miscellaneous: Other	0	0	0	0	0
		TECHNICAL DIFFERENCES			
TOTAL	-14	-12	-13	-15	-13
Individual Income	-5	-4	-5	-7	-3
Corporate Income	-2	-1	-1	-*	-*
Social Insurance	-5	-4	-4	-5	-6
Excises	-1	-2	-2	-3	-3
Estate & Gift	-1	-1	-1	-1	-1
Customs Duties	*	*	*	*	*
Miscellaneous: Fed	-1	-*	-*	-1	-1
Miscellaneous: Other	-*	-*	-*	-*	*

* Less than $500 million

Since January 1992, CBO has lowered its revenue projections for 1993 through 1997 by amounts ranging from $36 billioo in 1993 to $78 billion in 1997. Most of the changes--$26 billion in 1993 and $66 billion in 1997--resulted from changes to the economic forecast. The projected GDP for 1993 is $64 billion lower than it was a year ago and the projected GDP for 1997 is $306 billion lower. Because more than 90 percent of federal revenue comes from income and social insurance taxes, which depend on nominal income, downward revisions in nominal income lead to downward revisions in the revenue forecast. Despite the reduction in projected GDP, projected profits are higher than they were last year, resulting in higher projected corporate income taxes.

CBO made technical adjustments to its revenue projections of $12 billion to $15 billion per year between January 1992 and January 1993. The attached table shows the adjustments by revenue source. The adjustments to individual income taxes and social insurance taxes reflect data on tax liabilities for 1991, which became available at the end of 1992. The 1991 data show that liabilities in both sources lagged behind the growth in income; revenues for later years were adjusted to reflect the lower than expected ratio of tax liability to income. In individual income taxes, a drop in realizations of capital gains accounted for most of the lower liabilities.

CBO also lowered projected revenue from excise taxes. Slowdowns in the growth of taxable receipts of the airline and telephone industries and more rapid growth than expected in the use of tax-favored gasohol were responsible for much of this reduction.

Chairman SABO. Mr. McMillan?

Mr. MCMILLAN. Thank you, Mr. Chairman.

I think that question was a very good one, because it precisely hit the nail on the head as to why we can't answer Mr. Kasich's question, and that is, get control of the spending. It is because the legislation that we enact does not control spending.

You referred to the summit agreement, and we can argue back and forth about whether we should or should not have increased taxes. I would expect the net effect of that increase was relatively small economically because price changes on things like oil tend to offset it.

But what we failed to do in the summit agreement—and I would agree with the gentleman from Ohio that we did kick up discretionary domestic spending too much the first year—but on balance, after that we did a pretty good job on caps that kept discretionary spending under control. We did a pretty good job on the pay-go system on new entitlement programs.

Where we failed, on why those budget numbers are dramatically ahead of what you thought they would be, is that we are totally out of control on mandatory entitlement programs. We had this discussion yesterday when we were talking about whether or not to use baseline figures or not.

Your baseline figures are based on experience, and looking ahead now you are talking about medicare increasing maybe at a rate of 12 percent, 11 percent, medicaid at a rate of maybe 15 percent, when in fact the experience is last year medicaid increased 28 percent and medicare increased 15 percent. It is out of control.

And then when we start looking ahead and say, "What are we going to do?" We are not willing to face up to the fact that we have got to rein that in in some way. Why are we surprised when we don't set the terms of the deal, so to speak? Why are we surprised when it comes back totally out of control and the numbers are out of kilter?

I gave you a chart earlier and I am not going to go into that, but basically, if you freeze domestic spending, absolutely freeze it for the next 5 years, if you let all the other entitlement programs increase at the cost of living, and if you then put a real clamp on health care costs and that is limited to the cost of living plus the demographics effect, even then you can only reduce the deficit in 4 years to about 50 percent, which is what the administration says that they would like to do.

I think that is a perfect illustration of why things are out of control, and if you have any further comment on that, Doctor, feel free.

Dr. REISCHAUER. I share your concern about the mandatory programs, and I think reform in this area is clearly a key element in controlling the deficit. At the same time, we have to remember that these programs have built-in price increases in the form of cost-of-living adjustments (COLA), because we wanted to provide the beneficiaries with a degree of certainty about the safety net which was going to protect them in old age, sickness, and poverty.

And you have this terrible tension, you don't want to change these programs radically from year to year. How could people approaching retirement plan for their future if they had no idea

whether they were going to get COLAs, no idea what the inflation rate will be? They have no ability to respond themselves, because they have passed their working years. When their incomes fall, they can't reenter the job market as easily as younger people.

They do not have much control over the course of medical technology. Medical technology improves continuously. Medical expenditures rise tremendously. What are they to do? Say, "I am not going to have medical care in my old age?"

There is a reason that we have structured these programs the way we have. But we have to rethink some of this.

Mr. McMillan. I understand those reasons, but I had an example the other day—and I am not going to belabor this, we are going to talk about health care costs later—but where medicare could be lowering health care costs by not ordering CAT scans in cases where physicians don't think they are required. That is $1,100 a throw.

There are thousands of examples like that. We have got to be more intelligent about it. That means anticipating the effects of the decisions we make and not simply making decisions and letting, as you say, the weather or whatever control the result. I think that is sort of what we have done.

I think if we redo the summit agreement, and I hate to use that phrase because it gives it a bad name, but all of our efforts to live within targets with the prior Chairman, who was a strong advocate of it, and I was as well, have got to develop a plan to come to grips with entitlement programs. I think we all recognize that is a major challenge.

If I could just ask one quick question and follow-up to that of the gentleman from Ohio, so far as we know, we have the beginnings of an economic proposal that looks like a $31 billion increase in the deficit, half of it through increased spending, half of it through tax reduction, I presume in the first year. That wasn't spelled out so I don't know whether that is a 1-year or 4-year program.

The President also said that he expects to have a health care package within 100 days that will address the problem of the uninsured, and any sensible plan that I have seen starts at a figure of $30 billion a year to begin to do that.

In the context of that, shouldn't we be really looking at ways to reduce the deficit rather than ways to increase it? Would an action, a budgetary action that reduces the projected deficit by $31 billion for 1994, which is the year we will be dealing with, perhaps in the light of the improving economic news, provide a greater stimulus than a so-called spending stimulus of $15 or $16 billion?

Dr. Reischauer. It certainly would be good news to financial markets. I believe there would be an anticipation of lower interest rates, and that would obviously affect housing. It would affect investment. So there is certainly a case to be made.

Fiscal year 1994 begins in October. We are still some months away, and if the economy expands in the next two quarters as it has expanded during last two quarters, we will have a pretty solid base.

I know no more about this—probably less—than you do about the proposed stimulus package, but it strikes me that the numbers that are being tossed around sound more like budget authority

numbers than outlay numbers. X-billion dollars for increased public works, Y-million dollars for education and training programs; and they add up, according to today's newspaper, to nearly $30 billion.

It would be very hard to increase the deficit in year 1993 by that amount, because many of these programs spend out very, very slowly. That is one of the difficulties with infrastructure spending.

When you appropriate an additional dollar for highways, only 17 cents of it gets spent in the first year. When another dollar is devoted to contract authority in transit, less than 5 cents is spent in the first year, on average. It is actual spending that affects the deficit. It is actual spending that determines the stimulus. And so just to carry this example to an absurd level, if $10 billion were put into transit programs—and the spend-out pattern was similar to what we have experienced in the past—the grand total of the resulting stimulus would be on the order of $400 million. In other words, it would be absolutely trivial.

Mr. McMillan. Thank you.

Chairman Sabo. Mr. Kildee.

Mr. Kildee. Thank you, Mr. Chairman.

Dr. Reischauer, why does the CBO expect employment growth in 1993 to be twice as large as in 1992 when the real GDP growth is about the same? And how do you interpret the announcements of job cuts at such firms as IBM, Sears, Pratt & Whitney, General Motors, and Boeing? Do they mean the corporate restructuring which affected the economy in 1992 is continuing in 1993, and won't that mean slower job growth in your forecast?

Dr. Reischauer. It is true that these announcements that you refer to indicate that large corporations in America are continuing to downsize, continuing to go through corporate restructuring. This certainly will dampen overall job prospects. CBO has built that into our forecast.

Over the course of the last year output has increased much more rapidly than employment. We have seen this in our productivity numbers. Productivity has improved quite substantially.

We have also seen it manifested in the work week, which has lengthened in areas like manufacturing. When economic activity first picks up, employers like to put their existing work force on longer hours, rather than paying the costs—the training cost, the search cost, the fringe benefit cost—of bringing new workers in. It is always cheaper for employers to ask their current work force to do more.

In addition, employers do that because the risk is greater these days. They have seen this "recovery" now for more than a year. They have heard the economists say we are taking off, only to find out we have banged down on the runway again, and we are in our third takeoff at this point. Obviously they will be reluctant to add to their workforce.

CBO believes that as additional quarters bring substantial growth, employers' confidence level will improve, and their ability to ask their current workforce to add hours will come to an end. Productivity will turn back more towards the trend. All these factors together should lead to an increase in the employment numbers.

But I stress that this is a forecast, not a fact. As the past year and a half has shown, economists are fallible—a little better than weathermen, but not much.

Mr. KILDEE. It sounds like an optimistic forecast, considering what we read in the newspapers every day.

Dr. REISCHAUER. It is not very different from that of most other economic forecasters. We could be a bunch of elephants running over a cliff, but——

Mr. KILDEE. Those predicting seem to be looking at the most favorable possibilities. I know it is not just CBO, but General Motors, for example, has announced that they are downsizing their corporation. And when I read about the downsizing of our largest corporation, I worry that that might mean the downsizing of our economy.

Is there some relationship—what is the role of the auto industry in our economy? It is a big consumer of steel, glass, plastic——

Dr. REISCHAUER. It is a terribly important one, but one that is much less important than it was 10 or 30 years ago. The U.S. economy has been shifting increasingly over the last 100 years toward becoming a service-sector economy. And many good jobs, high-paying jobs, jobs requiring skills, are located in the service sector.

Although the media has focused a tremendous amount of attention on large, traditional corporations and the difficulties they are going through, we have to remember that smaller, nimbler companies are coming into existence and are expanding. IBM might be going through some very difficult times, but at the same time the software companies have expanded tremendously. Other computer companies like Dell have popped up and become extremely successful. You have to focus on the whole picture.

That is what economists try to do through the aggregate statistics, although the aggregate statistics don't make as good a story as IBM downsizing and its CEO being asked to leave.

Mr. KILDEE. I worry that some day we are going to look back and see we were deceiving ourselves when we say we can endure the loss of jobs to our manufacturing sector and make those up in the service sector. I just am not sure of that. Japan doesn't believe that, nor does the European Community. They feel their auto industry is a very, very important part of their economy.

Dr. REISCHAUER. Probably one of the best things the country could do to meet your concerns is to reduce the deficit, because the deficit lowers national savings, makes the Nation dependent on foreign capital, which artificially increases the value of the dollar. If we could make some substantial progress on the deficit front, we would have less need for foreign investment and borrowing, and our exchange rate would move in a more favorable direction for a period of time. This depreciation would boost net exports, because not only would it make our products more competitive abroad, but it would make imports to our country more expensive.

Is it painful? Yes, it is painful. But we have been living on borrowed time.

Mr. KILDEE. [Presiding.] Thank you. Mr. Shays.

Mr. SHAYS. I am having a very difficult time wrestling with an economic stimulus package which some of my colleagues have alluded to will raise the deficit, but would, in a sense, hopefully grow

the economy, and the very real need to reduce the deficit. And if you could give me some way to reconcile—I mean, politically. I would love to spend some more money for sewer treatment plants and roads and bridges and so on, but how can I justify it?

Dr. REISCHAUER. As I said before, there are arguments that could be used to justify it. First, you may be worried that the Congressional Budget Office and others are too optimistic; that there is a greater probability than we suggest that growth will slip back to the 2½ or 2 percent level. And, that is certainly a possibility. You may be interested in an insurance policy against that.

The second line of argument that you could take is that, given the unstable state of the economy and the inherent pain that is inevitable from measures to reduce the deficit, some modest amount of desirable spending or tax breaks will facilitate approval of a deficit reduction package.

If those spending increases and tax cuts were directed largely at areas that you think enhance the long-run productive potential of our economy, the danger associated with them from a deficit standpoint would be lessened. In other words, the danger would be lessened if spending increases and tax cuts focused on carefully selected productive investment activities, or if they stimulated added private sector investment.

Mr. SHAYS. If I was going to err in any direction, would I err more in the direction of deficit reduction or a stimulus package?

Dr. REISCHAUER. I have told you before that I am not here to make recommendations to this committee, but rather to lay out options and the ramifications of those options to you. That is really a judgment call.

Mr. SHAYS. It is a judgment call of which I have not the background you have. You are not going to tell me how to vote. I didn't ask you how to vote. But——

Dr. REISCHAUER. You are asking me how I would vote.

Mr. SHAYS. I am saying, if you are erring in a direction, which concerns you more, the deficit or a stimulus package? Otherwise you end up——

Dr. REISCHAUER. I think it is crystal clear from CBO's report that we think the most important problem facing this Nation and the one that affects virtually all of its other problems is the deficit.

Mr. SHAYS. Thank you.

Let me just ask something relating to what Representative Kildee asked. You know, I don't blame President Bush or President Reagan or Congress that GM was a bloated organization that was not productive. I don't blame government that the steel industry in past years was an industry that couldn't compete worldwide. One of the effects of worldwide competition has shown—has proven to us that our companies were not doing what other companies were doing worldwide.

I look at the downsizing at General Motors and say, thank God, not because it means industry is less important and services is more important, but that now we are going to have an auto industry that can compete, make a quality car. What would concern me with General Motors is that they downsized and became less productive, but my understanding is that now they are even more productive.

I know it has happened with Xerox and GE. There are a number of companies who downsized and became more competitive.

I guess this is a last area of questioning. Shouldn't I take some hope in the fact that the general public has downsized their debt, business communities have downsized their debt, the companies are producing more with less people, and now we can compete on a cost and quality basis with overseas markets? Isn't that probably one of the strongest features that could make us feel good about our future?

Dr. REISCHAUER. I think that is correct. I think we have been going through a set of adjustments to eliminate some structural imbalances that have developed during the last 50 years. We have been wringing these imbalances out of the economy—the private sector, the Government sector, the financial services sector—and we are building the base, as President Bush said a number of times, for a stronger, more solid economic expansion in the 1990's.

Mr. SHAYS. If General Motors didn't downsize, they would become almost irrelevant in world competition, it seems to me.

I thank you for your response to my question. Thank you.

Mr. KILDEE. Mr. Parker.

Mr. PARKER. Thank you, Mr. Chairman.

Dr. Reischauer, I am glad to have you here. I want to follow up on what Mr. Shays is talking about. He mentioned on page 1: Living standards grow so slowly in part because of the decline in the national saving rate over the past decade.

He also mentioned on page 2, "reducing the deficit is most directly reliable way to increase national saving and long-run economic growth."

Mr. Shays further stated that over the long run, a higher savings rate would encourage new investment, boost workers' productivity, raise real incomes and living standards.

What he didn't bring up is on page 3, where you said, "Increases in consumption will probably ease as households rebuild their savings."

And on page 7, you made the statement that beyond 1994, that your predictions, your projections are "based on trends in the labor force, productivity, and national savings."

On page 20 you made the statement, "Although my testimony is focused on the effects of eliminating the Federal Government's deficit, the economy could gain a similar long-term improvement if the government's spending on consumption could be reduced and its spending on well-chosen investments increased. Both strategies would shift resources from consumption to saving."

This is where I have a problem. I have heard conversations from members of this committee and we are going to hear the same thing each time we meet, basically the same words. It is kind of like the old joke, everybody needs a number, call out the number and everybody will know what to say.

The problem I have is that we have done nothing to encourage investment and savings. We have done nothing to penalize consumption. It seems to me—and I am not going going to talk about the entitlement programs and cutting and spending because you are going to be coming back on the 17th for that—it seems to me that the only way that we are going to change the direction we

have is to make a major change as far as encouraging savings, encouraging investment, and discouraging consumption in this country. Do you agree?

Dr. REISCHAUER. I agree, but it is hard to do, and we have gone through one of history's great natural experiments during the 1980's to see if we could increase personal saving rates.

National saving is composed of three elements: personal saving, that all of us engage in; saving by businesses, which is retained earnings; and government surpluses. When government runs a deficit, it dissaves; it absorbs resources from the other two components of saving.

During the 1980's, what happened? We lowered taxes, particularly taxes on saving and investment, with special breaks: IRAs, special homeowner accounts, and so on. The change in interest rates meant that real rates of return on capital rose very dramatically over where they were in the 1970's, when they were negative for the last part of the decade. And despite these apparent incentives, personal saving rates fell.

Mr. PARKER. But people are just like water. They follow the course of least resistance. And people—it is more advantageous to an individual to consume rather than to save. We don't have any reason for an individual to go out and save.

Dr. REISCHAUER. The reason you save is because you want to consume in the future. And what you are really doing is trading current for future consumption. Most of the economic literature suggests that persons are relatively insensitive to the after-tax rate of return on saving. It is very difficult to get them to increase their saving by changing the rate of return.

The most efficacious way of raising national saving is to reduce the dissavings of the Federal Government.

Mr. PARKER. But don't other nations have higher savings rates than we do, other industrialized nations? How do they do it? Have you looked at that?

Dr. REISCHAUER. Other nations have considerably higher savings rates than we do, and theirs are coming down at just about the same rate as ours. They are 20 years behind us, but on the same trajectory.

Some of this has to do with the structure of our economy and society. We are a consumption-oriented society. Somebody said to me once that the best way to increase saving would be to drop a neutron bomb on Madison Avenue and end the advertising industry as we know it, which makes you feel that you are judged by what you consume, the car you drive, and so on.

We have a credit system in this country that is unlike any in the world. We have democratized credit; anybody can get a credit card, anybody can buy a car with almost nothing down, many people can buy a house. In many countries, consumer credit is structured very, very differently. You have to make huge downpayments for the purchase of consumer durables.

Mr. PARKER. I don't want to stop any of that. If people want to buy a car or a house, that is no problem. The point I am trying to make——

Dr. REISCHAUER. I am trying to explain why the U.S. saving rate might be much lower than it is in other countries, where you have

to accumulate a big stock of assets to buy these things for which we are willing to extend credit.

Mr. PARKER. What I want to focus in on is that could we not have a consumption tax, have it offset with some investment incentives for individuals, and let the consumer choose? That is basically what I am asking.

Dr. REISCHAUER. We certainly could institute a consumption tax or shift our current income tax more towards a tax on consumed income. Either of those would increase the personal saving rate.

CBO has a paper which provides an estimate of what would take place if the United States had a value-added tax of about $150 billion. There would be a noticeable increase in personal saving as a result.

Mr. PARKER. I yield back the balance of my time.

Chairman SABO. [Presiding.] We will deduct it from the next time.

Mr. Smith.

Mr. SMITH OF TEXAS. Thank you, Mr. Chairman.

Dr. Reischauer, it seems to me the only thing increases as fast as the projected increase in the deficit is the size of the administration's deficit package. It started off at about $10 or $15, it has been going up in $5 billion increments, and I think the latest is about $30 billion.

We heard today figures indicating based upon the last month's economic growth, that that was the fastest growth in America in 10 years. The growth in the economy over the last quarter, the growth in the last quarter is the largest in a number of years. Yet, we still hear voices in the administration saying somehow if we don't spend the taxpayers' dollars on an economic stimulus package, those dollars are not going to be spent and invested. Somehow the Government knows better how to spend taxpayers' dollars than the taxpayers themselves.

On page 21 of your prepared testimony, you make this statement. "Across-the-board increases in public investment are unlikely to boost greatly the productive capacity of the economy."

Is there any part of the administration's proposed economic stimulus plan that you are familiar with that would actually boost the productive capacity that you are talking about, say, over the next 4 years, and increased long-term economic growth?

Dr. REISCHAUER. I have not seen any pieces of this package, so I do not have the faintest idea what is in it besides the speculation that has been in the newspaper, and that speculation has been too vague to base a judgment on.

Mr. SMITH OF TEXAS. Do you think an economic stimulus package is desirable, first question?

The other question is, do you think an economic stimulus package can generate the up to one-half million new jobs the administration says that it can?

Dr. REISCHAUER. I have not answered the first of your questions three times now. I am not going to change at this point.

If there were a fiscal stimulus package of about $30 billion—and I explained to you why putting $30 billion into infrastructure wouldn't lead to that much stimulus because it would spend out over a much longer period of time—but if we had investment tax

credits or more rapid-spending types of stimulus, an increase of 300,000 to 400,000 jobs would not be out of the ball park.

Mr. SMITH OF TEXAS. How long would those jobs last? Are we talking about permanent long-term jobs, or are they going to be short-term jobs that will be eliminated or phased out?

Dr. REISCHAUER. CBO is expecting the economy to expand over the next 4 or 5 years and the employment level to go up. The question here is not the end point; it is how quickly you want those jobs to appear in the economy.

Five years out, employment would be no greater than it would have been otherwise.

Mr. SMITH OF TEXAS. Let me just go back for a second. In that effect you are saying an economic stimulus plan would not be any net gain in jobs in the long term?

Dr. REISCHAUER. In the very long term, if you designed this very carefully and the spending went to increase the human capital and productivity of labor, it is conceivable there might be some marginal increase in jobs, but I do not think that is really what you are talking about.

The question is, will the number of people employed in the economy 5 years from now be substantially larger or not? Probably the same. But remember, those jobs would have appeared in the economy earlier than they would have appeared otherwise.

Mr. SMITH OF TEXAS. Okay. I understand.

It seems to me, Dr. Reischauer, that most Members of Congress today are so-called deficit hawks. Certainly that was the message that we received from the American people in the last election. But it seems to me that the real question of the day is not whether we are deficit hawks. I think the real question is whether we are spending hawks or tax doves.

And the reason I say that is, it seems to me the reason we have a deficit today is not because the American taxpayers are undertaxed, but because the Government over-spends. The American taxpayer today faces an all-time record burden when you combine the local, State and Federal taxes, and as you know the top one-half of wage earners today now pay over 90 percent of the taxes.

So my question to you in order to focus on the spending side of the question is, what areas of spending would you recommend or would you say we could cut to reduce the deficit? Specifically what areas of spending?

Chairman SABO. Quick answer, because we have to move on.

Dr. REISCHAUER. Have no fear. I was going to duck with this one, too.

Two weeks from now CBO will come out with our new volume of deficit reduction options which will have 200 to 300 different ways to reduce the deficit, most of which are on the spending side. It is your choice.

Mr. SMITH OF TEXAS. I don't appreciate your putting the question back because I thought you yourself, when we talked before, had specific ideas as to where the spending cuts could be made and what spending cuts would have the best and most dramatic impact on the deficit. Do you not have that opinion today?

Dr. REISCHAUER. When you ask me for an opinion, when you are in my office talking about the future course of policy, I treat that

as a different kind of discussion than a public discussion in front of a committee.

Mr. SMITH OF TEXAS. Fair enough.

Thank you, Mr. Chairman.

Chairman SABO. Mr. Coyne?

Mr. COYNE. Thank you, Mr. Chairman.

Dr. Reischauer, welcome. What is the current figure on tax expenditures for the current year? Do you have any idea? The last I looked it was about $400 billion.

Dr. REISCHAUER. I think it is in that ball park, but I have to warn you, it is very dangerous to add these tax expenditures together, because the cost of each one is estimated at the margin, as if everything else were staying the same. And so when you add them together, the sum represents an overestimate.

I would also add that it is important to realize that the rate structure that we have and the level of rates is not unconnected with the existence of these tax expenditures. If you did not have these tax expenditures, public opposition to the rate structure would probably be a lot greater and we would probably have a much lower set of basic rates.

Mr. COYNE. But I think it is fair to say we enact these tax expenditures on a fairly regular basis and we never go back to examine their usefulness to the economy.

And the question I have is, inasmuch as we are being told that maybe one of the remedies for the deficit is to cap the COLAs on senior citizens, retired Federal employees, retirees. Could we cap the growth rate of tax expenditures? And is that something that we could——

Dr. REISCHAUER. As I said, I believe it would be virtually impossible to do.

Mr. COYNE. On another subject——

Dr. REISCHAUER. That does not mean for a minute that we shouldn't reexamine these tax expenditures. And remember, when we are talking about cost-of-living adjustments, there is a big tax expenditure with respect to social security, because most social security benefits are not counted as taxable income.

Mr. COYNE. On another subject, restructuring the Federal debt, would it be to our advantage to restructure the debt towards shorter-term borrowing as opposed to the long-term borrowing that we have now, and would that be good public policy?

Dr. REISCHAUER. There has been a lot of discussion on this issue recently in the press, because over the last decade the maturity of the Federal debt has gradually lengthened, so that its average maturity now is about twice what it was a decade ago. And when the yield curve is very steep—where it costs a lot more to borrow long than it does to borrow short—you are obviously paying more.

Whether this is a wise idea or not depends on where you think interest rates are going over the next few years, and how you expect the yield curve to change over this period.

CBO expects rates to stay pretty much where they are now, except that they will rise up at the short end. So the advantage of making a move like this is considerably less now than would appear from all the estimates that have been floating around of what would have happened if we did this back in 1980 or 1981,

when the Government was paying 15.8 percent for long-term borrowing and before rates came down rather radically.

CBO is going to issue a report in a month or so on this topic. Preliminarily, I would say that if you shorten the maturity of the debt—not eliminating the long bond or doing anything radical, but scaling back the amount of 30-year and 10-year borrowing that we do—the savings would be about $300 million to $400 million in the first year, growing to perhaps $3 billion to $4 billion after 4 to 5 years.

But you have to keep in mind that there is more to this issue than interest outlays. There is also the stability of debt markets and the ability of the Treasury to manage this huge government debt.

There is also the question of how much risk you want to expose yourselves to on the budget front. If we were to go to nothing but 90-day bills and then we experienced a sharp rise in short-term interest rates, interest costs would escalate extremely rapidly. And already we turn over a little over half the debt within a 2-year period.

The question is, how much volatility do you want in your interest outlays?

Mr. COYNE. Thank you.

Chairman SABO. Mr. Cox.

Mr. COX. Thank you, Mr. Chairman.

Dr. Reischauer, it occurred to me since we were going to listen to you explain what is going to happen in the future, that it would be instructive to take a look at the CBO reports from the year before and the year before, and how we faired in those estimates. And here is what I discovered.

In 1989, CBO estimated that the deficit was going to be for fiscal year 1990, $140 billion. It turned out to be $269.5 billion. That was a 92 percent error. In 1990, CBO estimated that the deficit for fiscal year 1991, which remember started just a few months after the report was delivered, was going to be $138 billion. It turned out to be $269.5 billion. That was a 95 percent error.

The estimates for 1992 turned out to be, respectively, 115 percent and 115 percent estimating errors. And now what we are hearing is that in fiscal year 1993, the deficit is going to be 140 percent larger than you estimated it just a few years ago—even though the 1989 assumptions that you made were that there would be higher inflation in 1993, and a lower GDP.

We have in fact got rosier economic assumptions now than you had in 1989, and in 1990. And yet the deficit estimate has increased by 140 percent. And we have also got a track record that is absolutely abysmal. Why should we listen to you today?

Dr. REISCHAUER. I said at the beginning that this is an art, not a science. Making these kinds of estimates is very complicated.

The Congressional Budget Office estimates, as you point out, have been far off from the mark, but they have been better than other people's, and in particular the Office of Management and Budget's (OMB's).

I might go back and analyze for you the dismal record for the 1992 deficit estimate. If you recall, a year ago OMB estimated that the deficit in 1992 would be $400 billion. CBO's estimate at that

time was $368 billion. In the middle of the summer, which was three-quarters of the way through the fiscal year, we revised our estimate downward to about $314 billion. OMB revised its estimate down to about $330 billion.

The deficit turned out to be $290 billion. So OMB was off by $110 billion, in just a 9-month period, and CBO was off $78 billion.

Mr. Cox. If I might interject and reclaim my time, because I don't think the Chairman is going to give me a whole lot more, there was a debate in 1990, and OMB and CBO were on one side of the debate together, and House Republicans were on the other side.

Dr. Reischauer. Virtually all of CBO's estimating error—something like 80 percent—was attributable to one factor, and that is that CBO assumed that you would provide the Resolution Trust Corporation (RTC) with the funds it needed to carry out the savings and loan bailout, and the Congress failed to do that. So there was a huge swing in deposit insurance spending. There is no way that CBO can properly make judgments like that.

Mr. Cox. I just point out the CBO deficit estimate for fiscal year 1992 in both 1989 and 1990 was $135 billion, and the actual was $290 billion. There is no way the spread was accounted for by the RTC. It is just not true.

Let me ask a second question. You stated in your report that the deficit is a major contributor to the drop in the national savings rate, and has been over the past decade. I think I agree with that. If we raise taxes rather than sell debt to cover the deficit, won't this hurt the savings rate too?

Dr. Reischauer. The answer is, to a certain extent, yes. The increased taxes will come out of reduced consumption and reduced saving.

Mr. Cox. One other question I would like to ask——

Dr. Reischauer. You are not going to let me elaborate on that?

Mr. Cox. I am glad we agree, actually. I think that is useful. If the Chairman—I will tell you what. After I ask my next question, you can elaborate. I would just like to follow up on something that Congressman Parker was discussing with you.

If I heard correctly, you said that the national savings rate or the propensity of people to save is generally unaffected by the after-tax rate of return on savings. I just want to make sure I heard that correctly.

Dr. Reischauer. That is what the bulk of the economic studies seems to show.

Mr. Cox. Is that your view as well?

Dr. Reischauer. Yes, it is. I believe the findings of my profession, if that is what you mean, are that it is——

Mr. Cox. The after-tax rate of return——

Dr. Reischauer. [continuing] relatively insensitive to the rate of return.

Mr. Cox. So if we have, for example, tax-free IRA contributions, a whole lot of people wouldn't contribute to IRAs?

Dr. Reischauer. Many people might contribute to individual retirement accounts (IRAs). That is a different question from whether that activity increases national saving, because many people might merely be shifting resources from other forms of savings into

IRAs. There is a hot debate in the economics profession over the extent to which that occurs.

Mr. Cox. If we do that, would that in fact be a drain on other sources of savings, and not increase materially the savings rate?

Dr. Reischauer. Right now the majority of people are able to contribute to IRAs.

Mr. Cox. But not on a tax-free basis.

Dr. Reischauer. Yes, I am saying on a tax-free basis. The upper third of the U.S. population is not.

Mr. Cox. The cut-off rate, as you know, for being able to deduct it is very, very low.

Dr. Reischauer. It is not very, very low.

Mr. Cox. As to the number of people, that is right. But poor people, people of modest incomes, aren't the big source of opportunity for us. I mean, I think you are exactly right, but I just want to make sure that we agree that if you are interested in stimulating savings, you have to go after people with the opportunity to save.

Dr. Reischauer. And you also have to change the structure of the IRA.

Remember, the IRA had a fixed limit of $2,000. If you say to people who already are saving $5,000 a year, if you put money in an IRA up to $2,000, we will give you a tax break, they are affected by this at the margin, so we would not expect their behavior to change. Just by shifting resources from one form of saving to another, they would be capable of getting this tax break. If they added one more dollar to their overall saving, it wouldn't affect their taxes.

You have to provide incentives that were effective for those, as you say, who have the resources to add to their savings and the proclivity to do so.

Mr. Cox. I will, with the Chairman's discretion, not ask whether you want to elaborate on your earlier point——

Chairman Sabo. I suspect we are going to get votes right after 12 noon. We are moving quickly enough that I have my doubts people will want to come back after lunch. And so——

Mr. Cox. I am finished, but I wanted to extend the courtesy to the witness.

Chairman Sabo. We have six folks left who want to ask questions. So let's make the questions concise and answers concise.

Mr. Pomeroy.

Mr. Pomeroy. Dr. Reischauer, you have indicated that pursuing the goals of economic recovery through public investment and deficit reduction can be and perhaps should be pursued simultaneously. Is that correct? Can you pursue credibly both goals at the same time?

Dr. Reischauer. Certainly you can. It would involve reducing government consumption spending and shifting those resources into investment activities in the public sector. And that could happen at the same time as you were reducing the overall deficit, either by cutting spending or raising taxes.

Mr. Pomeroy. You have to pull your punch, however, on the public investment if you are going to cut domestic discretionary spending in order to work on the deficit goal.

Dr. REISCHAUER. This was going to be part of my elaboration on my answer to the previous question. Certainly we could shoot ourselves in the foot by cutting back public sector investment to reduce the deficit or by increasing taxes on saving or investment. And clearly we don't want to do that.

We would like to focus any tax increases that might occur in the direction of consumption, and reduce those areas of the government budget which are largely oriented toward consumption.

That is very difficult to do, because consumption in the Federal Government largely means transfers to individuals.

Mr. POMEROY. Thank you, Mr. Chairman.

Chairman SABO. Mr. Miller.

Mr. MILLER. A continuation of that question about consumption versus investment in our budget—explain why we should be going more in that line of thinking, that we should separate consumption from investment. Should we?

Dr. REISCHAUER. I am not at all sure we should. When you make your budget decisions, you certainly should look at the investment aspects of the budget as well as the consumption dimensions, and you want to be clear about those investment-oriented kinds of activities. But whether we should separate those activities and treat them differently from the rest of the budget, I think is a very debatable question.

There are theoretical reasons why it might make sense. But there are an infinite number of practical problems associated with it, not the least of which would be that the definition of public investment is elastic, to put it mildly, and might be subject more to political than to economic considerations.

Mr. MILLER. Thank you.

Chairman SABO. Mr. Cooper?

Mr. COOPER. I thank the Chairman.

Dr. Reischauer, you made the news yesterday with your Ways and Means testimony on health care, and in a very positive and friendly fashion, I would like to offer you a few suggestions on that, because having read your testimony, I was very surprised by the press reports.

Dr. REISCHAUER. I, too, was very surprised—having sat through the whole hearing—by the press reports. I thought they were about a different hearing than the one I attended.

Mr. COOPER. I fully realize that Congress usually asks you to do the difficult immediately and the impossible takes a little longer, but we still ask you to do the impossible. So I want to be very sensitive to that. But it seems to me that as full as your testimony was of qualifiers, of caveats, of warning labels, the message did not get through.

We need to be as sensitive in this area of reshaping one seventh of our Nation's economy as the Chairman of the Federal Reserve is in his testimony or as the Middle East peace negotiators are in their remarks.

The Socratic definition of wisdom to me has always been "the wise man knows what he does not know," and in the modern era we also have to say sometimes publicly "I do not know." And sometimes we should issue a press release saying just that, too, it seems to me.

The bottom line from what I could tell of what happened yesterday is that managed competition is too complicated to be able to moderate accurately. Single payer is a little easier but still hard. There is an inherent bias in any econometric plan towards easy solutions. That is the message I took away yesterday. And we are not even good at moderating single-payer programs.

Dr. REISCHAUER. I was very clear that CBO was not modelling either of these approaches, but that we were providing judgment based on a number of criteria. I tried to lay out the criteria.

I described the fact that the managed competition estimate that we provided depended crucially on how rich the basic benefit package was, and that if there were a more Spartan package than CBO had assumed, the proposal would save resources.

I also indicated that this proposal was going to cover 15 million to 20 million more Americans than are covered now. So despite the fact that under this estimate total health care spending would not be lower than it would be otherwise, many more people would be covered. And it strikes me that that is a positive message.

Mr. COOPER. It strikes me as a positive message to cover 15 to 20 million more people at the same cost with a better, more comprehensive benefits package than most people have today. But still, the bottom line is that message did not get through. So what do we do to get the message through?

I wish you could cite perhaps the Cowper's experience, which is a large pool of people having great success in controlling cost. Last year costs rose at a 6 percent level. This year at a zero percent level. That is a real-world experience that perhaps could be mentioned a little more frequently.

Also, I have got to come down to the bottom line of speaking in plain English in terms the press understands. Even Commerce Daily. Instant journalism is fun, but it is sometimes more instant than it is journalism. We have to make clear the press knows when your crystal balls are broken.

At least from what I am told, your team of estimators for managed competition and single payer were not even relying on the same assumptions, at least the night before you gave your testimony. So we have a comparison that looked like apples with apples, but in fact I don't believe your teams were coordinated. So we had a situation in which two different broken crystal balls were being used at the time your remarks were misconstrued. That is not helpful to anybody.

And I am not faulting you. I am especially not faulting your people. It is just an extremely sensitive area where I would like us to exercise maximum caution. You said yourself yesterday, according to one of the news articles, that the devil in health care reform may be the estimates.

Dr. REISCHAUER. That is a misquote. I said, "In the detail."

Mr. COOPER. I just hope the devil is not in the estimator. I think you should be extremely cautious in your remarks.

Dr. REISCHAUER. If you get the transcript to that hearing, I think you will find that I was extremely cautious and judicious.

I was quite upset by the instant news analysis that you refer to, and cornered that newsletter's reporter at this hearing this morning and chastised him.

Mr. COOPER. Well done. Thank you.

Chairman SABO. Mr. Lazio.

Mr. LAZIO. Thank you, Mr. Chairman.

Good morning, Dr. Reischauer. Assuming the ultimate goal is not just deficit reduction but long-term, sustained economic growth, is there a maximum incremental deficit reduction on a yearly basis that you think we need to temper our approach with?

Dr. REISCHAUER. The thing I fear least in this world is that the Congress will adopt more deficit reduction than the economy can bear. I do not lie awake at night worrying about that.

The estimates that CBO has done suggest, as I said, that a reduction of $48 billion to $60 billion programmatically—I am not talking about the interest costs—would knock something like half a percentage point off the growth rate, if there were no accommodating monetary easing.

If you think, as CBO does, that the economy is going to expand at about 3 percent anyway, you are talking about dropping the growth rate down to 2½ percent; 2½ percent is probably not politically sustainable, because the unemployment rate will hardly drop at all if we grow at about 2½ percent. We have to grow at somewhere between 2 percent and 2½ percent just to keep the unemployment rate steady, given the increase in productivity in the economy and the expansion of the labor force.

You would certainly want accommodating monetary stimulus to accompany that. But $48 billion or $60 billion a year is big bucks, and it is considerably bigger than the 1990 budget agreement; so I don't think we have to worry about where that limit is.

CBO had a simple rule of thumb during the negotiations at the 1990 budget summit, namely that the reduction should be no more than 1 percent of GDP, and today that would be about $60 billion.

Mr. LAZIO. Thank you.

Thank you, Mr. Chairman.

Mr. KASICH. Will the gentleman yield?

Doctor, would you say there is a minimal amount that needs to be developed for our efforts to be taken seriously in the first year? We always have over-the-horizon deficit reduction.

Dr. REISCHAUER. No, I would not. I think long-run credibility is most important. How do you get long run credibility? You adopt a series of measures that could be phased in gradually, but are written into law as they were in 1990—and it would take an act of Congress and the President's signature to undo them—then enforce those decisions as in 1990 with a budget process that makes it difficult to undo what you have done.

I think that is most important. Whether the cuts mounted rapidly in year 3 or 4, and weren't very large in year 1, is not as important.

Backloading the cuts entirely would cost credibility, too. The manana form of deficit reduction, that is, just nitpicking at it for the next 4 years and going gang busters in year 5, is not credible.

Chairman SABO. Mrs. Mink.

Mrs. MINK. Thank you very much.

Dr. Reischauer, I, like many people in the country, place a great deal of reliance on the estimates, as you put it, of the deficits. And the difficulty, I think, that a lot of us have is that those estimates

don't often pan out as you described in response to the Chair's question as to what happened to the estimates that were made in 1997.

So my question is, with respect to table 3 which you have presented this morning, are there any assumptions that have been made, in determining what these estimates are over these years up through 1998, that we should be aware of when we accept them as forecasts of estimates by your CBO office?

Dr. REISCHAUER. CBO details those assumptions fairly explicitly in this report, and of course we have a lot more detail back in our office.

Mrs. MINK. Are there some major assumptions——

Dr. REISCHAUER. The economic assumption is the important one. CBO lays out what our economic assumptions are and gives you some kind of feel for how the deficit would move if these turn out to be wrong.

Secondly——

Mrs. MINK. The economic assumption meaning the rate of growth, basely?

Dr. REISCHAUER. Inflation, interest rates, unemployment rates, rate of growth, the whole ball of wax.

The second very important assumption is that the Congress sticks with the Budget Enforcement Act limits through 1995. In other words, additional savings are going to have to be wrung out of the appropriations bills this year and next year, roughly $13 billion in 1994, and $26 billion in 1995. So CBO assumes that.

Third, CBO assumes that there will be no changes in fundamental tax laws and no changes in the structure of mandatory programs. We are really forecasting what will happen if the Government programs are put on automatic pilot.

Beneath that there are thousands of little assumptions about demographic growth, the numbers of people who would be eligible for Aid to Families with Dependant Children (AFDC) benefits, and items like that.

Mrs. MINK. In discussing the very large difference in the estimates in 1997, you indicated a large portion came from the decision that the savings and loan costs would be plugged in in 1997. What is the basis for that decision? Has it been plugged in in other places in your estimate?

Dr. REISCHAUER. Thank you for reminding me that a very important assumption in CBO's current report is that sometime early this spring, the Congress will provide the RTC with the resources that it needs to finish up the savings and loan problem, and that from now on, there will be no delay in that.

Mrs. MINK. And what is the amount of money that you are assuming that the RTC will need in order to meet its total cost?

Dr. REISCHAUER. We have suggested that the RTC needs an additional $50 billion over the next 5 years to complete the closing of insolvent thrifts and to capitalize the Savings Association Insurance Fund (SAIF), which is the successor to the Federal Savings and Loan Insurance Corporation (FSLIC) that will have this responsibility once the mess is cleaned up.

Federal law now requires that SAIF be provided with roughly $8 billion of capitalization through an appropriation or through the premiums that will flow into it by year 1998.

Mrs. MINK. So at what point in these charts do you begin to add that cost in your deficit estimates?

Dr. REISCHAUER. It is added in CBO's estimate for 1993 and beyond. But what you see in the early years is actually a decrease from our previous estimates because the RTC does not have money. So in 1993, it is not operating the way we thought it might back in the summer.

We have decreased our estimate of activity early on, but added activity later.

Mrs. MINK. Could you explain that other line in your various tables? I notice standardized and employment deficit has a footnote that it excludes cyclical deficit as well as deposit insurance and Desert Storm contributions.

Dr. REISCHAUER. This is really the deficit that an economist would urge you to keep your eye focused on. This is the deficit that is caused by our current revenue and spending structure.

The deficit is boosted higher than it would otherwise be when the country is in a period of economic weakness, when the economy isn't operating at full capacity. At that time, revenues are lower than they would otherwise be, spending for items like unemployment insurance and food stamps is higher than it would be, and so the Nation has a larger deficit than it ordinarily would have.

That economic weakness increased the size of the deficit last year by about $90 billion. In other words, had the country been operating at full capacity, the deficit would have been $90 billion less. It was operating at full capacity in 1989 and the first half of 1990, so this isn't a pie-in-the-sky notion at all.

In the recent past the United States has operated during some years at full capacity. So we take the cyclical deficit out to calculate the standardized employment deficit.

In addition, we take out the amount that is spent on deposit insurance accounts, because it has no substantial impact on economic activity. The spending in this area does not increase aggregate demand and does not add to pressures in financial markets. It is the resorting of liabilities. A liability to depositors at failed institutions is replaced by a liability to the bondholders from whom we borrow money to pay off the depositors.

In addition, the United States received, as you know, payments from abroad to help pay for the Desert Storm and Desert Shield activity. In 1992 that amounted to $5 billion, and since that really isn't part of our underlying revenue structure, CBO eliminated that to clarify the picture of events. And it is a picture of great concern because, as you see, this standardized-employment deficit, which is basically the structural deficit in our economy, gets worse almost steadily through the entire period.

Mrs. MINK. In terms of getting worse, what would be the impact if you added into that second column which we have just been discussing, standardized employment, the notion of the Government investment into jobs and infrastructure, all geared to the idea of increasing private productivity?

Is there a connection, and to what extent does this mean change, if the policy of the Government is to put monies into Government investment in matters that would have an impact on the productivity of the country? Does it make the change, or will we see no effect of change in this—what I consider to be——

Dr. REISCHAUER. This notion involves the question of whether the country should have a separate capital budget that is looked at in isolation from the operating budget. If you did this in the way that a private firm would—I am not sure I would regard it as appropriate for government accounting—your operating budget would be charged with the depreciation of the capital stock.

The depreciation you would include would be just about as much as we are spending now on the items in the budget that could be labeled investment, and so these numbers would actually change very little.

Mrs. MINK. May I have one more question?

Chairman SABO. Quickly. We need to get to Mr. Smith.

Mrs. MINK. What impact would the $30 billion stimulus package being discussed have on private productivity?

Dr. REISCHAUER. I think that in the short run, very little. I say that with great reservation because I do not know what is going to be in this package. But I am assuming that the spending side is going to comprise largely increased resources for infrastructure, education and training, and maybe vaccinations for children.

These types of activities are thought by many to have substantial payoffs, but the payoffs occur a long, long time in the future. When you are talking about education and training, you are often talking about a gestation period of 10, 15, or 20 years. So these activities are unlikely to do much to the productivity of the United States during a 5-year period. Even if added infrastructure spending were wisely allocated to projects that have high benefit-cost ratios, the next 5 years would be largely a construction phase. If anything, that might disrupt the private economy, because people will be in traffic jams on the highways while this construction was taking place. In the last half of the 1990's, the situation would turn around and you would get modest improvements in productivity.

But remember, this is a $6 trillion economy with tremendous amounts of capital spending already, and changes of a few billion dollars are not going to push the potential growth rate around by noticeable amounts.

Mrs. MINK. Thank you very much.

Chairman SABO. Mr. Smith.

Mr. SMITH OF MICHIGAN. Mr. Chairman, thank you.

Very briefly, Bob, help me understand the consequences of increased interest rates. If we take this $30 billion package as principal, and it makes us feel better economically and it does expand the economy, what are going to be the pressures on the Federal Reserve or the market system to raise interest rates if it expands the economy faster than somebody thinks it should?

And if we consider interest costs right now on our debt are not $200 billion but $290 billion, because after all, if we weren't paying the interest to ourselves it could mean reduced borrowing from somebody else, what are the consequences? What will a 1 percent interest rate increase have on the budget deficit?

Dr. REISCHAUER. The appendix in CBO's recent report has some rules of thumb that show you the impact of changes in various economic dimensions on the budget deficit. If interest rates increase by 1 percentage point, effective January 1, 1993, CBO estimates that it would add $5 billion to the current fiscal year deficit. If that jump continued throughout the fifth year, it would add $46 billion.

But I would suggest that a 1 percentage-point jump in interest rates would be a tremendously unlikely response to a $30 billion stimulus package when the economy is expected by everybody to be as sluggish as it is.

Mr. SMITH OF MICHIGAN. Just a quick follow-up question, then I am done, Mr. Chairman. The $5 billion estimate is predicated on the $200 billion cost; if I projected $290——

Dr. REISCHAUER. It is a net figure.

Mr. SMITH OF MICHIGAN. So the estimate could be argued to be roughly 50 percent more or slightly over $7 billion——

Dr. REISCHAUER. We are talking about gross interest, but I won't argue.

Mr. SMITH OF MICHIGAN. I am trying not to give you a chance to do that.

Mr. Chairman, it is very late and I will finish up with questions later. Thank you.

Chairman SABO. Thank you.

Let me ask a question. If in the 1980's in the private sector we had invested more in R&D and more in equipment and less in buildings, would we see a different economy today?

Dr. REISCHAUER. I think we would see a different economy, quite definitely, because we made a lot of investments in real estate that were clearly not economic. They are nonproductive. They are empty buildings. We have an 18 percent vacancy rate in commercial real estate right now, suggesting that we did not need the great surge in office space that was created during the 1980's.

If those resources had gone into plant and equipment instead, we would have more capital stock behind each U.S. worker and productivity and wages would be higher.

Chairman SABO. So it does make a difference in terms of both relatively short-term and long-term economic growth where we make our private investments?

Dr. REISCHAUER. Certainly.

Chairman SABO. What about in the public sector? You got to that issue a little bit in terms of—and I suppose what is productive investments is a relative question, but to the degree that our transportation system works efficiently, does that have an impact on productivity?

Dr. REISCHAUER. Yes, it does, and I think it also has an impact on general standards of living, irrespective of its impact on private-sector productivity.

Chairman SABO. When we deal with the wide variety of interest rates we see today, which interest rates are the most relevant for long-term economic investment in the country?

Dr. REISCHAUER. I think most borrowing by companies for major investment occurs in a 5- to 10-year, rather than a 30-year framework. Many people focus their attention on the 30-year government bond, and imply that it has some profound significance for the pri-

vate sector of our economy. But most borrowing goes on in a 10-year time frame or less.

That is also the important time frame for U.S. households, because the average mortgage only lasts for 5 to 7 years, then the individual moves and buys another house with a different mortgage rate. So a 30-year bond rate is not particularly relevant for housing finance.

Chairman SABO. Which rates govern what happens on your fixed mortgage? If you go out and buy a new mortgage, and you have *X* percent interest, 8 percent interest today, what is that most closely related to in Government borrowing?

Dr. REISCHAUER. These are different markets, and so they are not really comparable.

Chairman SABO. Yes, I understand.

Dr. REISCHAUER. For the most part, mortgages are issued by banks or thrifts. They are then packaged together and securitized and bought by investors or mutual funds. As I said, the average duration of a mortgage turns out to be about 7 years, I believe.

So if you are putting money into alternative investments, you would compare the investment you were making in a securitized mortgage, such as a Fannie Mae or Ginnie Mae security, with alternatives of an equal maturity, which would be 7 to 10 years.

Chairman SABO. How long are the Ginnie Mae securities normally for? When they purchase a package, that is really a 30-loan that they are buying.

Dr. REISCHAUER. It is a pool of mortgages that will have different maturities. They might package together 15-year or 30-year mortgages, and this package then pays the purchaser not only the interest but also the returned principal. So you are getting a return, a check from it that is a combination of interest and principal repayment. And the packages diminish fairly rapidly in size by the time you get to the seventh year.

Chairman SABO. Is there any good analysis of housing construction in the 1980's in terms of what type of housing we bought with the totality of dollars we spent on housing?

Dr. REISCHAUER. I am sure there is. I do not have it at my fingertips. The quality of homes increased steadily up until about 1990 in terms of the proportion that have air conditioning, two bathrooms, two-car garages, and so on. That steadily increased in the post-World War II period until 1990. I think there was some dip at that point.

Chairman SABO. Any analysis of the relative amount of total construction that went into—and I am not sure how you——

Dr. REISCHAUER. Multifamily versus single-family house?

Chairman SABO. Total housing construction, how much of it went to houses over $1 million, say, 500 to a million, 250 to 500, 100 to 250, under a hundred.

Dr. REISCHAUER. I am not aware of anything like that, but CBO will be glad to look into it and provide you any information we can get for the record.

Chairman SABO. If you have some idea, I would be interested in looking at that.

[The information follows:]

New One–Family Houses Sold by Calendar Year and Sales Price (Categories in dollars, not adjusted for inflation)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Number of One–Family Houses Sold (In Thousands)												
Under 60,000	234	158	135	148	123	118	87	61	50	46	34	30
60,000–79,999	149	119	130	205	200	193	182	121	110	93	76	69
80,000–99,999	68	63	61	113	125	141	165	138	121	103	84	88
100,000–119,999	31	31	26	49	56	68	92	84	87	81	63	65
120,000–149,999	29	29	28	50	59	73	83	99	108	103	88	86
150,000–199,999	33	21	19	34	42	54	77	84	93	97	86	82
200,000–249,999	a	14	15	24	34	22	34	38	45	49	41	35
250,000 and up	a	b	b	b	b	18	30	46	61	76	61	54
Total	544	435	412	623	639	687	750	671	675	650	533	509
As a Percentage of All One–Family Houses Sold												
Under 60,000	43	36	33	24	19	17	12	9	7	7	6	6
60,000–79,999	27	27	32	33	31	28	24	18	16	14	14	14
80,000–99,999	13	14	15	18	20	21	22	21	16	16	16	17
100,000–119,999	6	7	6	8	9	10	12	13	13	12	12	13
120,000–149,999	5	7	6	8	9	11	11	15	16	16	17	17
150,000–199,999	6	5	5	5	7	8	10	13	14	15	16	16
200,000–249,999	a	3	4	4	5	3	5	6	7	6	6	7
250,000 and up	a	b	b	b	b	3	4	7	9	12	11	11
Total	100	100	100	100	100	100	100	100	100	100	100	100
Median Sales Price												
In current dollars	64,600	68,900	69,300	75,300	79,900	84,300	92,000	104,500	112,500	120,000	122,900	120,000
In 1991 dollars	106,908	104,153	98,731	102,970	104,739	106,707	114,328	125,290	129,522	131,806	128,072	120,000

SOURCE: Congressional Budget Office tabulations of data from U.S. Bureau of the Census, Current Construction Reports, Series C25, New One–Family Houses Sold and For Sale, various issues.

a. Included in 150,000 – 199,999 Category
b. Included in 200,000 – 249,999 Category

Chairman SABO. We look forward to having you back again in 2 weeks. We are interested in the health care issue, not simply with the totality of dollars involved. I think we all understand that. But the degree that we can understand sub-totals of what is driving cost, whether it is demographics, to what degree it is different services driving the costs, would be helpful.

I have tried looking over the years at some of the numbers I get, and many times they are not that helpful. You maybe see that hospital costs are going up, but you don't know which portion of hospital costs. To a degree it is basic maintenance of somebody being there versus other costs. I am not sure how good our reporting requirements are.

My understanding is that outpatient service is something that is growing very, very rapidly, so the degree that we can have detail in understanding what is happening with both the demographics and services would be helpful to the committee.

Thank you very much.

[Whereupon, at 12:20 p.m., the committee was adjourned.]

[Additional material submitted for the record follows.]

PREPARED STATEMENT OF HON. JERRY F. COSTELLO, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Mr. Chairman, I am pleased to be here today as we receive the economic and budget outlook from CBO Director Reischauer. As a new member to this committee, I am pleased to be part of the debate that will help shape the future of our nation. We are facing tough questions relating to deficit reduction and economic stimulus. While the process of bringing the deficit under control will undoubtedly be difficult, I am confident that Congress and the Administration can work together to produce a fair economic package. I am looking forward to hearing the economic projections of Director Reischauer and welcome him here today.

Recent deficit forecasts show that deficits are expected to be higher than previously estimated. The new estimates show a significant increase not only over the deficit forecasts issued by CBO and the Office of Management and Budget last winter, but also over the deficit estimates issued last summer, as well as over those discussed at the Little Rock economic summit in December. In short, this nation has dug itself into a deficit hole that is deeper than recognized a year ago. We must find the best way to restore our government to fiscal health.

It is my feeling that the public is likely to be more willing to tolerate sacrifices for major deficit reduction if the economy is growing at a significant rate and generating jobs and income gains. I believe that my State of Illinois would benefit from the added boost that an economic stimulus package could provide. Yesterday, I had the opportunity of listening to the testimony of my Governor, Jim Edgar who testified before the Public Works and Transportation Subcommittee on Economic Development. He influenced my support of an investment package by citing examples of job growth and the need for infrastructure improvements in Illinois. I am hopeful that we will address the possibilities of short-term economic stimulus package at this hearing.

Mr. Chairman, thank you for calling this hearing. I look forward to hearing today's testimony.

PREPARED STATEMENT OF HON. CHARLES W. STENHOLM, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Dr. Reischauer, as always, the CBO's Economic and Budget Outlook, just released last month, is a wealth of valuable information, analysis and projection. In addition, this most recent edition of the Outlook seems to provide a lot more editorial comment than normal, especially with regard to budget process reform. In some of those editorial comments, I find myself in agreement with CBO. In others, as you might guess, I adamantly disagree.

I do not wish to engage in a detailed discussion about the balanced budget constitutional amendment here today. I am hoping the Chairman might allow an opportu-

nity later this year for a hearing where that debate might be more appropriate. Particularly given the fact that 29 of the current 42 Members of this Committee support the balanced budget constitutional amendment, I believe there would be considerable interest in such a hearing.

Limitations of time and appropriateness notwithstanding, I do have to say that the arguments you used in the Outlook are some of the more specious arguments which we have heard and responded to years ago and which, in my opinion, don't have a leg to stand on. It may be that you have not had the opportunity to review some of the answers we have provided to those very questions.

Not wanting to monopolize the hearing debate time on this one specific issue, I am sharing with you in writing, and submitting for the Record, some of our answers to CBO's criticisms of the balanced budget amendment. I will be contacting you personally to discuss with you what concerns remain for you after you have had a chance to review our responses.

Responses to CBO's Criticisms of the
Balanced Budget Constitutional Amendment

CRITICISM: There is no consensus on what the budget to be balanced under a strict rule should include or on how to measure conformity with the balanced budget rule.

RESPONSE: The Stenholm-Smith amendment does not require that a single document, a "budget," be written in balance. While universally referred to as requiring a "balanced budget" its mandate is both simpler and more comprehensive, requiring a balance (or surplus) of receipts relative to outlays. As currently used and reported, both "receipts" and "outlays" are well understood, inclusive concepts used with consistency in the budgetary process. The amendment deals with actual spending and taxing bills, and how actual outlays conform to actual receipts. Taking any item "off-budget" would have absolutely no effect on the operation of the amendment.

Procedures for measuring compliance would be appropriately left to implementing language, as required by Section 6 of the amendment. It is the expectation of the authors of the amendment that any implementation language will include a mechanism for arriving at accurate and responsive estimates.

Relevant Language:
Section 6. The Congress shall enforce and implement this article by appropriate legislation, which may rely on estimates of outlays and receipts.
Section 7. Total receipts shall include all receipts of the United States Government except those derived from borrowing. Total outlays shall include all outlays of the United States Government except for those for repayment of debt principal.

CRITICISM: A balanced budget amendment lacks credibility because it interferes with the ability of the federal government to combat recessions through automatic stabilizers or discretionary fiscal policy.

RESPONSE: A balanced budget amendment does not prohibit the federal government from using fiscal policy to respond to economic downturns. Instead, it simply increases the threshold of difficulty for spending beyond our means. The credibility of the federal budget has already been undercut by the structural bias to spend and borrow in good times and bad that has resulted in a massive structural deficit. The massive structural deficit severely restricts the ability of the federal government to effectively utilize countercyclical fiscal policy. A balanced budget amendment is intended to level the playing field by restricting the use of fiscal stimulus to unusual situations instead of routinely. In restoring this level playing field, H.J.Res. 290 strikes a reasonable balance between requiring fiscal responsibility and allowing flexibility.

Rather than try to anticipate every economic contingency in Constitutional language, the authors wrote a sufficiently flexible amendment. Several responses are possible to a contracting economy, for example:

1)Congress can only control what is reasonably controllable. When resulting outlay changes are small, no adjustment would be necessary.

2)To the extent such outlay increases are foreseeable and fairly certain, a mid-year adjustment might be necessary, relying on offsetting rescissions or other account adjustments, as is the case when a supplemental

appropriations must be made deficit-neutral.
3)If Congress and the President agree that the economic situation warrants outlay levels above the receipts ceiling, achieving a 3/5 majority to approve such spending is not an insurmountable hurdle.

Relevant Language:
Section 1. Total outlays for any fiscal year shall not exceed total receipts for that fiscal year, unless three-fifths of the whole number of each House of Congress shall provide by law for a specific excess of outlays over receipts by a rollcall vote.

CRITICISM: The President and the Congress could get around an apparently rigid balanced budget constraint by using timing mechanism and other budgetary gimmicks such as using overly optimistic economic assumptions to achieve short-term budget targets.

It is the intent of the authors that Congress should include provisions preventing the use of such gimmicks in complying with the amendment in implementing legislation required by Section 6. In addition, Section 7 of the Stenholm-Smith amendment defines total receipts and total outlays to ensure that all government inflows and outflows are counted for the purpose for the amendment. This would foreclose the most commonly anticipated loopholes from being created. A transparent mis-estimate would be subject to the very public process of budget-making and would make the culprits vulnerable to the political impact and reaction to their behavior. Furthermore, Congress would still have to pass a debt ceiling increase by a three-fifths vote if the Treasury were required to borrow money to cover an excess of outlays. The debt provision provides an incentive for truth-in-budgeting more powerful than any provision in current law. Any transparent gimmicks would be exposed to the public process by the required vote on the debt limit.

Relevant Section:
Section 2. The limit on the debt of the United States held by the public shall not be increased unless three-fifths of the whole number of each House shall provide by law for such an increase by a rollcall vote.

CRITICISM: The President and Congress would pass costly spending on to states and local governments (through mandates) or private businesses (through regulations).

RESPONSE: Given the fact that CBO strongly argues for the long-term salutary effects of deficit reduction and given the fact that this criticism relates purely to the pressures created by deficit reduction, not by a Constitutional Amendment, this is a particularly surprising argument to come from CBO.

Congress and the President currently resort to mandates on state and local governments as a result of current budget discipline and are likely to do so as long as the federal deficit inhibits the establishment of new federal spending programs. The balanced budget amendment is not likely to increase this practice beyond already high current levels; to the contrary, helping move the budget towards a no-deficit state ultimately will relieve some of the pressure to pass off responsibilities to the state and local governments.

The appropriate response to this problem is legislation such as H.R. 140 introduced by Representative Gary Condit which would prohibit consideration of legislation that would impose unfunded mandates on state and local governments.

CRITICISM: The Balanced Budget Amendment is not a substitute for a balanced budget plan. Even if the amendment were passed and ratified by the necessary three-fourths for the states, the hard work would remain to be done.

RESPONSE: The sponsors of the amendment have never claimed that the amendment was a substitute for a balanced budget plan or that it would be a "magic bullet" to solve the deficit crisis by itself. Instead, the amendment is a tool to force Congress, the President and the public to own up to the tough choices that need to be made.

The Constitution requires Congress and the President to take the necessary steps to carry out Constitutional mandates. Congress is empowered to make all laws that are "necessary and proper to execute the mandate of the constitution." The President and Members of Congress take only one oath, promising to "preserve, protect and defend the constitution."

In addition to this inherent imperative implicit to any Member of Congress or President who sincerely seeks to uphold his/her oath, Section 6 of the Stenholm-Smith bill specifically requires the adoption of legislation necessary, appropriate, and reasonable to enforce and implement the Balanced Budget Amendment. This section creates a positive obligation on the part of Congress to enact appropriate implementation and enforcement legislation. As a practical matter, this language simply requires what is inevitable and predictable. It is a simple statement that, however well-designed, a constitutional amendment dealing with subject matter as complicated as the federal budget process needs to be supplemented with legislation. It is a means of owning up to the truth in the arguments made by many Members of Congress -- both supporters and opponents -- that Members must expect to do more than cast this one vote to pass this one amendment, to ensure that deficits are brought down and, ultimately, eliminated.

Currently, under the Constitution, if Congress fails to make appropriations or provide for further Treasury borrowing the government faces risk of shutdown. We will face the same result if Congress fails to pass necessary legislation required by implementing legislation.

The prospect of a balanced budget amendment becoming effective several years hence would have an immediate salutary effect on the budget process as policymakers are forced to take actions to ensure that the budget will be in compliance when the amendment takes effect. Furthermore, a balanced budget amendment would serve as a Constitutional guarantee that we adhere to a long-term deficit reduction package through the achievement of a balance and beyond, instead of attempting to circumvent the statutory discipline we include in a deficit reduction plan.

Relevant Language:
Section 6. The Congress shall enforce and implement this article by appropriate legislation, which may rely on estimates of outlays and receipts.

BOSTON PUBLIC LIBRARY
3 9999 05982 184 1

ISBN 0-16-040195-X